INFLATION

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By

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LONDON
P. S. KING & SON, LTD.
ORCHARD HOUSE
WESTMINSTER, S.W.1
1919

PREFACE

THE Prime Minister and the Chancellor of the Exchequer have declared in Parliament that the excess of public expenditure over revenue threatens the country with national bankruptcy and ruin.

The gloom of the forecast is justified by figures which are perfectly plain and ought to be understood by every thinking person.

In the last Budget estimate before the war (1913–14) the total produce from taxes was put down at £160 millions. For the present financial year the charge for public debt is £400 millions and for pensions £100 millions, that is to say more than three times the pre-war revenue from taxation.

Subsidies for bread, railways, trade and unemployment will absorb at least another £160 millions.

In addition every item of ordinary public expenditure has risen greatly—the Navy and Army, the Civil Services, Education.

Even this is not all. An unknown liability is to be incurred for a magnificent scheme of housing. The local authorities are encouraged or commanded to follow the imperial example. All over the country rates are rising—in Glasgow, in many ways the great exemplar of local government, the rise for this year is two shillings in the pound.

The effects of this enormous increase of debt and taxes may be hidden for a time by the pleasing fallacy (examined in the last chapter) that internal debt and taxation make no real difference to the nation as a whole but involve a "transfer of resources" from the less deserving to the more deserving with an increase in the national balance of happiness.

But there is no such escape from the burden of foreign indebtedness. Our adverse balance of trade is over £700 millions. The invisible exports by which in pre-war days a smaller adverse balance was met have all fallen off. We have less to receive from foreign investments, freights, and financial commissions.

The fall in the American exchange has alarmed our Food Controller. It ought to alarm the Chancellor of the Exchequer still more. The increase in the prices of our imported food is a minor evil compared

with the effect of a continued fall in the exchange on British credit.

If our currency were on a sound basis and the paper were really convertible into gold, the foreign exchange would correct itself. Gold would be exported, prices in the home country would fall, imports would be diminished and exports increased until the balance was restored.

But when the home country is on a paper basis there is no such automatic correction of the exchanges. On the contrary the evil will probably be aggravated by the provision of more paper money to meet the rising home charges. In the concrete, if our food rises in price, labour will want more bonuses and "there will be a greater demand for money" to be met by more paper.

When the revenue does not meet the expenditure how can any increase of expenditure be met except by an increase of promises to pay? How can the promises be made effective without the increase of paper money?

Such are some of the more staring features of the economic situation.

What are the signs apart from pessimistic, in place of optimistic, speeches that any real remedies are being provided for the growing peril?

According to the *Labour Gazette* for August, increases in wages for July affected 200,000 workpeople, and over a million and a half workpeople obtained reductions in the hours of labour. The cost of living has risen to 115 per cent. at August 1 above the pre-war level as compared with about 105 at the beginning of June.

The Prime Minister has issued a memorandum (August 20, 1919) summarizing the main points in his programme under five-and-twenty headings. Every one of them means new public expenditure and an increase in the burdens of governmental management. The two Bills specially offered to Parliament as a kind of holiday task are designed to lessen still more the hours of labour and to raise the rates of payment.

It is precisely as if when the submarine peril was at its worst the people had been encouraged to eat more and to work less.

The only explanation of the reckless disregard of the official warning of impending national bankruptcy and ruin is that the people and their representatives do not believe in the truth of it. It is the wolf in the fable over again. The wolf must come to the door before the seer of the wolf will be believed.

The principal cause of the disorder of the

body politic is the abuse of paper money. "The great expansion of currency is the root of all our economic ills." [1]

There are, no doubt, other causes, but their effects are aggravated by this primary evil. All the ordinary business of life is carried on in terms of money. Profits and wages, salaries and taxes are all paid in money. To get the money abroad that is needed to pay for our imports we must send money's worth or borrow. Borrowing means that in the end more money's worth must be sent. We must always go behind the money to the things the money stands for.

The adverse balance of trade is serious enough, but there is another kind of unfavourable balance which, as Adam Smith observed, is far more dangerous—the balance, namely, of consumption over production.

During the war we have eaten up a large amount of our capital and have not made good the depreciation of much of the rest.

Our greatest present need is to get back to a sound monetary system and to get rid of the mirage of inflation.

I have called this book Inflation *sans phrase* because the word suggests besides

[1] From the City Notes of the *Times*, August 22, 1919.

the usual monetary meanings all sorts of flabby moralities and bombastic utterances. We want to get back not only to hard money but to hard thinking.

We live in a world of money, and when anything goes wrong with the money our whole world is shaken.

J. SHIELD NICHOLSON.

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September, 1919.

EXPLANATORY NOTE

The substance of this book was given in a series of lectures to the staff of Barclay's Bank and an abstract was published in their Magazine from May to August. I was specially asked to make the subject as simple as possible and to go back to the foundations, and I have tried to make good the request. J. S. N.

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CHAPTER I

THE ABANDONMENT OF THE GOLD STANDARD DURING THE WAR

THE argument of the present chapter may be stated in two very short sentences.

(1) Before the war this country possessed a complete and effective gold standard. (2) During the war the conditions necessary to the maintenance of that standard have ceased to exist.

These sentences are taken from the summary of the conclusions of the *Interim Report of the Committee on Currency and Foreign Exchanges after the War* (Lord Cunliffe's).

The Report has described so very clearly the nature of the working of the Gold Standard before the war and also the extent of the abandonment during the war that perhaps it may be thought superfluous to go over the ground again.

What I propose is to carry the argument of the Report a stage further back: to show how the gold standard as maintained before the war

was in accord with fundamental economic principles and how during the war, with the abandonment of the gold standard, these fundamental principles were violated. The political necessity or expediency of the abandonment is beyond the scope of the present argument.

Even when the subject is regarded strictly from the economic standpoint, we must recognize the complexity and the difficulty.

Strictly speaking the gold standard is supposed to provide only a *standard unit for the measurement of values.* This provision of a standard unit of measurement is generally put down in the text-books as the first primary function of money. But the text-books also go on to show that both in theory and in history this measurement function is closely associated with other functions of money. Both in time and in logic we may say indeed that the provision of a *medium of exchange* is the first requisite of money. In any case, the *medium* and *measure* are closely connected.

The measurement, however, seems wider than the exchange function. We measure the values of things that are not being exchanged at all or only infrequently, e.g. the lands and houses in the national inventory.

For the present purpose it is enough to say that the effective maintenance of the gold standard before the war implied first that all values in this country were measured in terms of the

pound sterling, and secondly that all the different media of exchange were definitely related to the pound sterling. All the various forms of representative money represented in the last resort so much gold coined or coinable.

The standard measure of values must provide not only for the present but for the future. It must be a *standard for deferred payments.* More and more in the course of economic progress monetary contracts involve the element of time. Take the case of life insurance. A man may pay year after year for fifty years or more his annual premiums, and yet if the standard measure changes its real meaning the provision for the family melts away.

The monetary provision for *deferred payments* is so important that it is often named separately as one of the primary functions of money.

It is in the performance of this function that inconvertible paper generally comes to grief.

Besides these functions a good monetary system ought to provide for the *store of values* and for the *transfer of values* from place to place.

The importance of the store of values function is seen by the great reserves of money kept by banks. The transfer of value function is illustrated by the complex mechanism of the clearing house and of the foreign exchanges.

Underlying all these functions we have to take account of law and of custom with the force

of law. We have to take account also of the limitations of the powers both of law and of custom and of possible conflict between the two. The best illustration is what is called Gresham's Law. This law is law only in the economic sense. Shortly expressed it says that bad money drives good money from circulation. Gresham's law in general can only operate by breaking the law of the land. For example, to take good gold money from circulation and to melt it, early in this war was declared a criminal offence.

Let us pass from this short resumé of the functions of money to the application.

The application is this. When the Currency Committee reported—in the sentences which I quoted at the beginning—that before the war this country possessed a complete and effective gold standard they meant that all these varied monetary functions were well and duly performed in connection with the gold standard. They meant that gold was the foundation of the whole elaborate monetary system by which this country conducted not only its own financial transactions but financial transactions with every part of the world. The whole of the elaborate mechanism was run with a minimum of friction and with a minimum of governmental control. The system worked so smoothly that although the Bank Act of 1844 was an essential part of the mechanism, very few business men could have

given even a broad outline of the provisions of the Act.

In theory the gold standard—taken in this extended sense as the foundation of our whole monetary system—had certain errors, weaknesses and inconsistencies. Volumes of criticism have been written on it. But after all it worked—and it worked well. Adam Smith, the greatest of free traders, said of the Corn Law that with all its faults it was like the laws of Solon the best possible having regard to the circumstances and prejudices of the time. In this sense the gold standard was like the laws of Solon. The gold standard before the war may also be compared to the British Constitution, full of theoretical defects and anomalies but in many ways all the stronger for the defects.

At the present juncture it is well that we should realize the weakness as much as the strength of the pre-war system. Defects that are negligible in normal times may become dangerous under stress of war or other hazards.

The gold standard in its present form in this country only goes back to 1816—the year after Waterloo. But it has a long history—it was the direct descendant of the old pound of silver which was the standard measure before the Norman Conquest. How the original pound weight of silver came to be changed into the sovereign with a curious weight expressed in a number of grains

and a long decimal of a grain is one of the most instructive and interesting chapters in history. Gold coins at first were of foreign origin and passed at their commodity value. In time they were issued by our own Mint and had a rated value to silver. For centuries England had the single standard of silver—and for centuries the bimetallic standard. The great Ricardo thought silver a better standard than gold. Many later economists have thought bimetallism—or a combination of the two—the double standard as it used to be called, a better standard than either alone.

But one thing stands out very clearly. If we compare our gold standard or rather our whole monetary system as based on the gold standard—if we compare this system in the beginning of our financial year in April, 1914, with the system which we actually had in April, 1919, namely a system based on paper money issued by the State, we shall soon see that the old system was unquestionably better. The gold standard may have had its imperfections in details, but the new paper standard is weak in the foundations. That in other words is the verdict of the Currency Committee. As soon as possible they say let us get back to the pre-war gold standard. If it is to be reformed let it be reformed with caution. Do not reform it altogether.

I proceed to show more in detail the methods

of working of our pre-war system. And first of all we must notice the very close connection between gold as a measure of values and gold as the basis of the various media of exchange.

I recall these well-known facts to show that when we look to the history of the gold standard we find that it was adopted by this country after a very long trial of other standards.

Historically we may say of the gold standard as was said of America, that it was discovered by accident. And yet in both cases in the course of industrial progress the accident was bound to come.

For centuries silver was the principal universal world money. Even Adam Smith always regarded silver as the typical standard money. Gold has no such long unbroken tradition as silver as a universal world money.

On the outbreak of the great Napoleonic war period, this country was theoretically on the double standard. During that period the actual standard, as in the present war, became paper. On the conclusion of peace, gold was made the sole standard and the silver was made definitely in this country a token coinage. In the outside world some countries, notably in the East, preserved the single silver standard. Others, including France, Germany and the United States, kept up the double standard.

The double standard in other countries broke

down when Germany after the war of 1870 followed the example of England and adopted the gold standard. Gradually and more or less perfectly gold became the effective standard of the whole commercial world.

In the meantime this country had strengthened the gold standard by the Bank Act of 1844. By that Act our working of the gold standard was made practically automatic[1] and independent of governmental management. Therein lay its greatest strength.

Let us now pass to the theoretical imperfections of the gold standard.

The imperfections of a standard of value founded on weight were recognized long ago and economists exercised much ingenuity in trying to discover an invariable standard of value as contrasted with the variable gold or silver. Adam Smith himself thought labour was such a standard. Value in terms of labour, he maintained, was real as compared with value in terms of money which was only nominal. By the time of Mill, however, it had come to be recognized that a perfect standard of value—an absolute invariable

[1] The maintenance by the Banking Department of the Bank of England of a gold reserve adequate for the effective support of the credit system at home and abroad, involves the most skilful and prudent management. But that is another question which would arise with any standard. See below, pp. 26, 33.

standard, is unattainable and indeed unthinkable except in a world as fixed and unmoving as a world of fossils. Mill goes so far as to say that we cannot even suppose any state of circumstances in which it would be true—that is to say—that the standard money must always have the same purchasing power or same exchange value.

Why should I emphasize this impossibility of getting a perfect monetary standard? When we realize that perfection is impossible we must be content with imperfection. We must have some measure of value, and we must appeal to experience to see what kind of measure has the least imperfections in practice. A standard of value may fail of perfection in many ways. There is no simple test.

The two primary functions of money, namely the measure of value and the medium of exchange, are inseparably connected. The bond of union is the quantity of the money. The standard measure varies with the purchasing power. The purchasing power varies with the quantity of money in circulation. The standard measure of value is very different, for example, from the standard of length. The length of the yard stick does not vary with the number of yard sticks in use.

We can lay down conditions under which the variation in purchasing power of money would

be *exactly* in proportion to the variations in the quantity of money. But these conditions are far removed from the actualities of the modern world. The relation between the quantity of money in circulation in any country or in the whole commercial world and the level of prices in that country or the world can only be expressed (at all accurately) by taking account of a number of variable causes and conditions. To describe all the causes of variation would take a book. My argument only requires a reference to the great foundations of the Quantity theory.

Some people have been so much appalled by the complexity of the quantitative relation between money and prices that they have denied the reality of any connection. It is forgotten that in the actual world—in the physical no less than in the economic world—all the relations are highly complex if we try to attain any approach to accuracy. We know, for example, that there is a connection between latitude and temperature —that the further we recede from the equator the colder it becomes. In the extremes—at the poles and the equator, the proposition is taken as self-evident. Between the extremes the proposition is true in a general way but in particular cases is liable to be counteracted. To tell the precise connection in these cases even for a long period and still more for a short period involves a difficult inquiry. But no one would deny the

close connection between the variations in the exposure of different parts of the earth to the sun and the corresponding warmth of the place or the season.

And so it is with the quantity of money and the level of prices. Take it broadly the connection is as real and as self-evident as with the climatic connections. If we have a healthy distrust of even the self-evident axioms of economics the connection can be proved by the appeal to experience. Great discoveries of the precious metals—for a very long period as already observed silver was of more importance than gold as money—have been followed by a general rise in prices. But with the great mass of gold accumulated in the course of time the annual additions, even if large, only operate slowly and to a limited extent. Before the war general world prices were advancing in response to the great discoveries in South Africa and America, but the advance as given by the index numbers was very small and very slow as compared with the advance in the present war.

Not only are the annual additions of gold to the common monetary stock of the world relatively small, but in normal times the trade of the world grows from decade to decade; and not only the trade, but all the other transactions that are carried out by means of money are also growing; or putting everything together we

say, that the work to be done by the money is steadily increasing. This means that to keep up the same level of prices more money must be forthcoming. If the yield of the mines were to remain stationary or to fall, there would not be enough to repair the annual wastage in the West and to satisfy the sacred thirst for gold in the East. General prices would fall. And fall they did for twenty years after the early seventies; and one chief reason was because the gold supply fell off compared with the work required of it. The connection was not by any means simple, but the general trend was plain enough.

This slow response of the level of prices to changes in the quantity of gold is one of the great merits of gold as the standard measure. Time is allowed for the necessary readjustments, or at any rate the change in the real meaning of monetary contracts is not violent.

The best confirmation, however, of the quantity theory of money as it is commonly called, is found not in the case where the money is gold, which is limited by the high cost of production, but in the case where the money is paper which depends for quantity not on the cost of the material or on any other real limitation, but on the arbitrary power of the government of any country. Since the invention of paper money all the great commercial countries have had experience of inconvertible paper money. And

in every case after a certain point the excess of issue has raised prices roughly in proportion to the quantities issued. The standard example is the *assignats* of the great French revolution. In Russia under the Bolshevists the example has been repeated. The value of the paper rouble in Bolshevist Russia is rapidly approaching the value of waste paper. Apart from these extreme cases—which are so appalling that in this country they seem for us impossible—there are many historical cases well within the limits already exceeded in the present war. There was our own case in the Napoleonic wars—there was the case of the United States in the Civil war. There are other instances also, still more moderate—cases where the convertibility of the notes was only suspended for a time and the excess of issues was relatively small.

The *Wealth of Nations* was composed nearly one hundred and fifty years ago, but Adam Smith had already had experience of the evils, not only of inconvertible notes, but of suspended convertibility. It was this experience that led the great apostle of natural liberty to approve of very considerable restraints on the powers of banks to issue paper money. "To restrain private people, it may be said, from receiving in payment the promissory notes of a banker for any sum whether great or small, when they themselves are willing to receive them; or to restrain a

banker from issuing notes, when all his neighbours are willing to accept of them, is a manifest violation of that natural liberty, which it is the proper business of law not to infringe but to support. Such regulations may no doubt be considered as in some respect a violation of natural liberty. But those exertions of the natural liberty of a few individuals which might endanger the security of the whole society are, and ought, to be restrained by the laws of all governments; of the most free as well as of the most despotical." (*Wealth of Nations*, p. 133: Nicholson's edition.) Before the war it is well known that, all the world over, restraints were actually imposed on the issues of notes by banks. In no country were the restraints so severe and rigid as in this country. And I may say in passing that in no country—in spite of or perhaps in consequence of this severe restriction on note issues—had banking proper reached so high a stage of development. Our deposit banking was the most free of the whole world.

If, however, experience had shown that the issues of notes by the banks, as a part of their own credit system, ought to be limited, still more clearly had experience shown that the issues of paper money by the *government* ought to be placed under the most stringent *limitation*.

Again, if we appeal to experience we find that the most effective and the most beneficial form

of the principle of limitation is the practical rule of immediate convertibility.

So long as the paper money is subject to this practical limitation and so long as the real limitation is not evaded by all sorts of suspensory devices, or by the control of the export or the use of gold,[1] the other regulations matter very little. In this country the rule of convertibility of the notes was carried to the greatest extreme. The margin of safety was often said to be ridiculously large. But after all, the expense of keeping a large gold reserve, and of keeping, as we did before the war, say a hundred millions of gold in active circulation, was negligible compared with the vast interests involved. People of large financial imagination who objected to our rigid note issue and to its extreme dependence on gold, never really thought of the expense. A paltry expense of that kind would never be considered. What they really meant was, that the restraints on the notes imposed restraints on the other forms of bankers' credit. Even the relaxation of the German system with its elastic limit was supposed to be favourable to the expansion of banking in general and with banking of trade in general. This is not the occasion to discuss

[1] "Convertibility of the note into coin is deprived of all its virtue when laws against melting and exportation of the coin are present andeffective." (Prof. Cannan's *Money*, p. 54.)

the relative merits of German and British banking before the war. My present point is that even in Germany the issues of notes were very strictly restrained and the elastic limit method was only a variant on our own system. In the first years of the war the Germans took special pains to observe the legal regulations regarding note issues by trying to keep the due proportion of gold.

The efficiency of the gold standard was maintained not only or even principally through any fear of a fall in the purchasing power of gold, or in other words any fear of a general rise in prices. Your practical man is never afraid of a rise in prices. It is the fall that seems so dreadful. A short time ago I read in the papers a pitiful remonstance by the Chicago dealers in dead pig. They said that if prices were not kept up they would lose, I forget how many, millions of dollars. I was almost persuaded to become a socialist. Why should they not lose millions of dollars after making the people of this country eat millions of pounds of their abominable bacon?

But I must not be led astray from the argument by the aftermath of bad bacon. Possibly here and there some far-seeing and well-instructed men of business were fully aware that the rigidity of our banking system in preventing great movements in general prices was a good thing for trade. I dare say a good many of them thought

so in the autumn of 1907 when the Americans gave us an example of the other thing.[1]

One great advantage of our pre-war system from the practical standpoint, apart from the maintenance of the purchasing power of gold, was the stability of the foreign exchanges. In the *Report of the Currency Committee* this point is made of fundamental importance. They do not say that the gold standard must be restored in order to bring down prices. Indeed as practical men desirous of influencing practical men they give reasons for thinking that the fall of prices will in any case be slow[2]—small by degrees and beautifully less. What they are concerned with is the foreign exchanges. It was the same in the Napoleonic period. The famous Bullion Committee[3] took no evidence on the rise in prices—though they pointed out the evils. What troubled them was the fall in the value of the pound sterling in relation to foreign currencies. It was to get rid of this evil that their Report was adopted.[4]

The war has shortened all our memories. But we all remember as soon as we are told that on September 1, 1915, the American exchange fell

[1] Cf. the opinion of the late Dr. Charles Gairdner of the Union Bank of Scotland on the danger of high prices.

[2] See *Currency Report*, p. 9, para. 38, also para. 18.

[3] Cf. Smart's *Economic Annals of the Nineteenth Century*, p. 241 n.

[4] *Ibid.*, p. 253.

to $4\frac{1}{2}$ dollars to the pound (4·51), and that it was considered one of the first duties of our government to stabilize the exchange regardless of the expense.

It is more pleasing to go back to earlier days. By 1819 the gold standard had been effectively restored by the resumption of cash payments, and the foreign exchanges of this country were effectively stabilized without the intervention of the State. There were some exceptions, more apparent than real, in times of crisis, but, for nearly a hundred years, taking a broad view, our monetary system, firm based on the gold standard, was of all systems the best in preserving the stability of the foreign exchanges.

The Currency Report has explained very clearly the processes by which this stability was normally secured—especially by the adjustment of the Bank rate.

In other countries a good deal more trouble was taken with the management of the foreign exchanges, and especially in recent years variants of the *gold-exchange standard* system came into favour. This reference again opens out a wide subject for controversy. It is enough to say that though a form of the system was considered expedient under the circumstances for India, none of the variants were adopted in London, though on the Continent the plan was followed in a very mild form.

Recently attempts have been made to show that Ricardo approved in principle of the gold exchange standard. Ricardo is perhaps the greatest of all the writers on Currency. He had two unequalled advantages. The first was that he lived all his life in the City of London and for long was regarded as the leading financial authority. That was one advantage. He lived and worked through the Napoleonic war. He knew paper money at first hand. The second great advantage of Ricardo was that he followed Adam Smith before the *Wealth of Nations* had been perverted into a set of one-sided dogmas. Ricardo often criticized Adam Smith in detail but especially as regards the foundations of money and credit he made more sure the foundations laid by Adam Smith.

Whether the authority of Ricardo can be quoted in support of the present proposals for the extension of the gold-exchange standard is very doubtful. This is not a convenient occasion to discuss the point. But the present is a very convenient occasion to quote two sentences which might with advantage be hung up in all the banks in the country.

The first is this—written when the paper money was inconvertible: "In the present state of the law [he is referring to the Bank Restriction on conversion of paper into gold] the Bank Directors have the power of increasing or reducing the

circulation in any degree they think proper: a *power which should neither be entrusted to the State nor to anybody in it.*" (p. 406 MacCulloch's Edition.)

The second text runs: "*The only use of a standard is to regulate the quantity and by the quantity the value of the currency*—and without a standard it would be exposed to all the fluctuations to which the ignorance or the interests of the issuers might subject it." (*Ibid.*, p. 400.)

To resume the main argument: Before the war the Gold Standard was effectively maintained in this country because the principle of convertibility was strictly observed. At the small end of the system the proportion of bank notes to gold simply depended on the convenience of people. Any one who wished could change his bank notes for gold or get notes for his gold as he pleased. In cashing a cheque the option of the form of the money—whether paper or gold or other coins—was left to the customer. Again at the big end of the system foreign countries could convert their claims into gold without let or hindrance. London, unlike some other capital cities, was strictly a free market for gold.

The remarkable thing about this free market was that the whole business was conducted on a less amount of gold kept in reserve than in other great monetary centres. The point was that, owing to the perfect convertibility of all

our forms of representative money, a stream of gold was always flowing in and flowing out and the cistern never ran dry.

Of course on occasion of panic the reserve fell below that safety limit but as observed by the great Ricardo: "Against such panics Banks have no security *on any system*; at no time can there be in a bank or in a country as much specie or bullion as the monied individuals of such country have a right to demand." (p. 406.)

Before the war it used to be said that this country had carried the economy of gold to the verge of danger—and warnings were constantly given that the central reserve should be increased. And yet in practice it was found that the methods adopted to replenish the central reserve in case of need were sufficient. Everything depended on convertibility—not on the piling up of great stores of gold. In the same way the food supplies of this country were made adequate for the effective demand not by great national granaries or other stores but by continuous adjustments of the flow of the various supplies.

Of course in gold as in food supplies there is such a thing as running it too fine. And in such necessaries it is well to leave a good margin for safety. Beyond a certain point economy of gold is not only a mistake but a danger to national well-being. It is like the economy of truth. The interchange of social civilities would hardly be

possible without a certain economy of truth—but at the same time when you come to the real foundations and to the things that really matter, then the economy of truth is destruction. So it is with gold reserves.

We found out in this country by experience that the best way to allay a monetary panic was to pour out the reserves freely in the usual channels on the usual security. "Be bold" was the rule.

In other countries this rule has been imperfectly understood. They pile up masses of gold. They make elaborate provision for the concentration of all the gold. But they forget the one thing needful. They forget to use the gold.

They are like the old Vicar of Wakefield who gave each of his children a guinea to keep in their pockets with strict injunction that they were never to spend it.

One of the favourite foreign pre-war ideas of the gold standard regarded it as a kind of nuisance that was to be circumvented or evaded as much as possible. Another conception answered to that of a great idol—a kind of golden calf for worship in time of trouble but not for use even in time of need.

The old English method—the pre-war method—was to use the gold and to feel we were using the gold—to know we were all the time in touch with hard money and not walking on air.

Recent foreign banking legislation seems to be dominated with the dread of emergencies. It is like loading the ship with life-saving apparatus instead of keeping a better look-out. Elasticity of note issues is also a great present day cure-all. As if we had not had enough of this kind of elasticity in the last five years and as if the greatest of all our present needs was not the restraint of the elasticity.

The effective working of the gold standard before the war was maintained by making adequate provision against *three possible drains of gold.* We shall see the nature and the extent of the abandonment in the war by considering how these three drains were managed before the war. Under the pre-war system the outflow from the central cistern by the three drains was unrestricted. By continuous replenishment the cistern was kept full enough to meet the outflow. Under the system adopted in the war the cistern was kept even more full than in pre-war times but it was kept so full by stopping up the drains.

The *first* drain under normal conditions was to supply the needs of internal currency. With a certain level of prices a certain amount of gold was needed for cash payments and if not gold some form of legal tender which would be universally accepted without demur, such as bank notes or for smaller payments, token coins. In time of revival of trade after a period of depression

there was always a certain demand for more gold or notes based on gold. There were also at certain times of the year exceptional demands on the central reserve, as for example to meet the requirements of the Scottish term days. It was only in times of very severe crisis that there was any difficulty in providing for the internal circulation. At these times on occasion the Bank Act of 1844 was suspended, that is to say, more notes were issued than the legal cast-iron limit. The excess issues were, as a matter of historical fact, really negligible in amount and the mere announcement of suspension sufficed to restore the ordinary forms of credit.

In every case the suspension of the Act was a temporary emergency measure and did not interfere in the slightest degree with the real working of the gold standard system. The suspension did not mean that the notes became either by permission or by practice inconvertible. The Bank of England, in spite of the suspension, had to meet any claims on it in gold. Its notes did not become legal tender by the bank itself. As a matter of fact for internal purposes, even in a severe crisis, there was no run on the banks for gold as such. In a word the drain for internal currency was always kept well under control.

The same thing applies to the *second* drain for *non-monetary uses*. A certain amount of gold is

used in the arts, and a certain amount, or rather an uncertain amount, is required for export to the East as a commodity. Gold is a precious metal as well as the principal basis of money. With a general rise of prices or increase of material prosperity the demands for gold for these purposes rose and caused a certain demand on the central reserve. In this connection it must be observed that the price of gold was definitely fixed. This only means that a certain quantity of gold is made into a certain number of coins. The coins weigh just as much as the gold. You can only change the price of the gold in terms of sovereigns by changing by law the weight of the sovereign.

Before the war this *second* drain—the drain for the arts or for non-monetary uses—was also easily provided for. That is to say the cistern could be easily filled enough to meet these requirements.

The *third* drain was to meet foreign demands for monetary payments. And this was the real source of danger. A sudden demand might be made for a large amount—and the event not foreseen. With the observance of absolute convertibility there could be no delay—and at any rate delays in banking are specially dangerous. The management of the central reserve so as to provide against the dangers of a possible foreign drain demanded the greatest prudence and foresight, that is to say if convertibility, which in

this case means the free market for gold, was to be maintained.

Now consider what has happened to this foundational principle of convertibility and to the three drains in the course of the war.

The principle of convertibility, with regard to the notes in internal circulation, has been *de facto* abandoned, although not perhaps in law or in theory. But in currency it is always the practice and not the law that counts. The mere substitution of one pound and ten shillings for sovereigns and half sovereigns was a matter of very little importance in itself.[1] As a matter of fact in Scotland we had one pound notes from the beginnings of banking and people as a rule preferred them to gold. Nominally also the new currency notes could be presented at the Bank of England and changed into gold on demand. In practice, however, there was no demand for conversion of this kind.

It was very soon provided by the Defence of the Realm Act that any melting down of gold coins was criminal and so far the drain for the arts was choked up.

At the same time the export of gold was in

[1] I advocated the issue of One Pound Notes for England in a paper read to the British Association in 1888—reprinted in *Money and Monetary Problems*, p. 208.

practice not permitted except with official sanction.

There was not much publicity about the stopping up of these three drains. It was only when an occasional malefactor was caught interfering with the governmental stoppings that ordinary people knew that any stoppage had taken place.

It seemed then as if the gold standard had been abandoned—or at any rate the old way of working it—and yet nobody was a penny the worse. Who was the worse for using notes in place of gold, or who was the worse in war time for buying less gold ornaments? And if the government managed the foreign payments and took good care that the precious metal—still more precious in time of war—should not find its way into the hands of the enemy, who could or would complain?

But as events showed this threefold suspension of convertibility—however necessary as a war measure—was accompanied by dangers. And in time the dangers were realized.

The beginning of the real abandonment of the gold standard is to be found in the provision that the banks could obtain currency notes to the extent of 20 per cent. of their deposits. But besides this, the provision for the issue of the currency notes was drawn in such an elastic manner that apparently anybody on good cause shown could get the notes. No public intimation

was ever made either of the real conditions of issue or of withdrawal.[1]

Before the war the whole of our credit system rested on the central gold reserve. By this extensive substitution of notes for gold the whole superstructure was cut away from the foundations.

No real limitation was placed on the issues and in practice, if not in law, the principle of convertibility was abandoned.

With this expansion of credit when it was freed from the restraining influence of the gold standard, the deposits have more than doubled and the currency notes have overtopped three hundred and thirty-three millions.

No one will pretend that these large issues of notes have simply taken the place of the gold formerly in circulation. Even to begin with that argument was of very doubtful value because the gold withdrawn from active circulation was for the most part drawn into the banks, and as everybody knows the most effective monetary use of gold is not in the pockets of the people but in the coffers of the banks.

The progress and the consequences of this great expansion of paper money and of the credit

[1] In effect as explained in the *Currency Report*, p. 5, para. 11:—" fresh legal tender currency is continually being issued, not against gold, but against government securities "—promises to pay against other promises to pay.

of which it formed an essential part will be considered later on.

By way of conclusion I may emphasize one other great principle of monetary science abundantly confirmed by experience. Commodities pay for commodities and money is only the medium of exchange. If we include under commodities labour and all the other things, tangible and intangible, that bear a price, and if we include under money not only the actual standard metal but all the forms of representative money, we see that the proper working of the money medium is one of the essential conditions of civilized life.

But in itself money is still only a means. Like the telegraph wire or the wireless telegraph its function is one of communication.

I do not wish to underrate the importance of the monetary functions in the progress and in the maintenance of civilization. Quite the contrary. The exchange of commodities and services is practically impossible without a medium that will be accepted. Money from this point of view may be compared to the roads between different markets. Without roads trade is practically impossible. In the course of progress the roads are improved and supplemented by waterways and by railways and we may now say by air-ways. And so it is with money. Metallic money has been supplemented by all sorts of improved means of exchange. The change is

by no means so recent as is commonly supposed.[1] Adam Smith observed of Scotland that within twenty-five or thirty years of his time of writing, say from 1750–75, the business of the country, i.e. of Scotland, had come to be carried on almost entirely by the paper of the great banking companies. He calls attention also to the corresponding great increase in trade, especially in Glasgow. He was told that the trade of Glasgow had doubled in about fifteen years after the first erection of banks there, and that the trade of Scotland had more than quadrupled since the erection of the first two banks in Edinburgh.

But the same Adam Smith goes on to say that if the trade has really increased in this proportion it is too great an effect to be accounted for by the sole operation of this cause.

Money in all its forms is after all only the medium. Adam Smith compared *money* to roads and he also said that of all agricultural improvements that of road-making was the greatest.

Let me conclude by quoting the immortal metaphor of Adam Smith. Everybody knows it. But these are the days when we have to remind one another of old truths.

"The judicious operation of banking by pro-

[1] John Law's Bank (1716–1720) is still the best example of excessive issues of notes. Cf. *John Law and the greatest Speculative Mania on record*. *Money and Monetary Problems*, p. 165.

viding, if I may be allowed so violent a metaphor, a sort of wagon-way through the air enables the country to convert as it were a great part of its highways into good pastures and corn fields and thereby to increase very considerably the produce of the land and labour." (p. 131.)

But the highways, whether on the land or in the air, of themselves do not produce a single grain of corn.

Just now there is a kind of mania for the improvement of the material means of transport. Even the barren moors of Scotland are to be traversed by light railways and by roads fit for motors. If the mania develops every remote village will have its aerodrome to facilitate the landing and repair of the aeroplanes. In the same way there is a mania for the improvement and multiplying of the forms of credit. It is forgotten that the roads and the credit are only the means between the ends and if the ends are empty the traffic is useless.

I began this chapter by recalling the old familiar learning on the functions of money. I shall end as I began with this difference. I shall now put the old learning in the form of questions.

Has the actual standard measure of values maintained its stability? Has it not rather suffered both a general and a specific depreciation?

Is our actual currency—our medium of exchange

for internal purposes—really based on gold, now that the principal legal tender consist of notes not convertible into gold and only covered by gold to the extent of about 8 per cent. of the issues ?

Is gold still our real standard in foreign trade and finance when the export of gold is prohibited ?

And lastly: Can we doubt the justice of the words quoted at the beginning from the Currency Report: "During the war the conditions necessary to the maintenance of the gold standard have ceased to exist" ?

CHAPTER II

THE INFLATION CONSEQUENT ON THE ABANDONMENT OF THE GOLD STANDARD DURING THE WAR

Economists long ago gave up the search for a simple short and sufficient definition of the word money. All sorts of things have been considered as money in different times and places from cowries up to cheques, and these various things have performed, in a more or less effective way, the various functions of money. Different forms of so-called money have their different uses. Confronted with these variations in the forms and uses of money economists have varied their analysis of money according to the purpose in hand. "Money is that money does," is the short definition by the late Professor Walker. Yet curiously enough he does not include bank deposits or bank money.[1]

There are of necessity similar difficulties in the search for a simple and sufficient definition of the term inflation. Inflation is by common consent

[1] Walker's *Money*, p. 405.

the name of a monetary disease. People who approve of our financial policy in the war say there has been no inflation, or very little, or no more than could be expected and so on. They do not like the word. They prefer elasticity or expansion or some other neutral term. The confirmed optimist, the man who reckons the national debt as an addition to the national wealth, speaks, not of the inflation, but of the wonderful creative power of our credit system.

Perhaps the best solution as regards the meaning of the term inflation—and its use is now too common to be disregarded—is to say that inflation means an abnormal increase of money. The subject then divides itself into two parts: First, there is the question of fact—Has there been an abnormal increase and to what extent? And secondly,—Was the increase necessary, or beneficial, or was it overdone and deleterious?

On the question of fact there can now be no doubt. All the world over—practically in every country—there has been an abnormal increase in the various forms of money. Every land is overflowing with money of different sorts.

In most countries the increase is most marked in the paper money in the shape of notes—bank notes or governmental notes. In the United Kingdom, for example, in addition to large increase in the bank notes proper by the end of

1918 there were in circulation well over three hundred millions of currency notes issued by the government. The number has increased since.

In France the note issues are very much greater. In Russia the issues are best described as boundless.

In the countries with the abnormal note issues, the gold has been displaced or withdrawn from circulation, though some of it is still jealously guarded by the banks. Much of the gold displaced by the belligerents has overflowed into the neutral countries. In this way we may say that in these neutral countries there has also been an abnormal increase in the gold money—although we do not usually speak of an inflation of the gold in circulation. The outstanding example of this effect is Sweden which at last refused to convert more gold into currency.

That inflation in the sense of an abnormal increase of money has become practically universal during the war is shown by a striking summary of the principal facts published recently.[1]

One of the most curious results is that, comparing the end of 1918 with June, 1914, the gold reserves held by the banks in the belligerent countries had actually increased by about one-

[1] See the Financial and Commercial Review of the Swiss Bank Corporation for 1918.

third (from £932 millions to £1,249 millions, i.e. by over £300 millions).

The increase, however, of the paper money in the shape of notes in the belligerent countries was much more astounding. The increase (including Russia) of the notes was about twenty-fold.

Compare now the neutral countries. There the gold reserves of the banks had increased nearly three-fold (in comparison with a moderate one-third in the belligerents); and the notes had increased by a rather less amount. That is to say, in the neutral countries the notes had increased—but not quite so much as the gold in reserve.

In comparing notes and gold it is the proportion that is generally of most interest. Taking this basis of comparison before the war the proportion of gold held against notes in the belligerents was about 70 per cent., and in December, 1918, it had fallen to about 5. In the neutrals, on the other hand, before the war the proportion of gold to the notes was about 50 and in December, 1918, it had risen to about 60.

In comparing these large increases in notes with the gold in reserve, it has lately become the fashion to leave out Russia. I think this is a great mistake. On the contrary, Russia is just the example that we should always have before us. Before the war the proportion of gold to

notes was greater in Russia than in any other country. It was over 98 per cent. By the last return it is put down (I presume at a guess) as at a fraction of 1 per cent., 0·7. Instead of trying to minimise the general increase of paper money all the world over, we ought at any rate to face the facts; and the greatest and most alarming of all the facts is the monetary situation in Russia.

Before the war the outstanding example of the follies and of the dangers of inconvertible notes was the case of France in the great Revolution. For the future the paper roubles after the Bolshevist revolution in Russia will take the place in the text-books of the French *assignats*. The Russian example is writ so large—and it is actually before our eyes—that it cannot be overlooked or misread. Undoubtedly one of the chief causes of the present economic ruin of Russia is the deluge of paper money. By no means leave out Russia when you reckon up the abnormal increase of paper money in the world. "Never forget Russia" is the safer rule.

With regard to the abnormal increase of money in this country during the war, I may, perhaps, be allowed to refer to a paper I read to the Royal Statistical Society in June of 1917.[1] The paper is too elaborate for a short summary,

[1] Republished in my *War Finance*, p. 81 sq.

but one or two of the salient results may be indicated.

An abnormal increase was shown to have taken place in every form of money—using the term in an extended sense.

Gold of course had been displaced from actual circulation, but its place had been more than filled by currency notes. In the beginning of the war period it was difficult to estimate the rate at which the gold disappeared from circulation. It was never formally withdrawn. Appeals were made to the patriotism of the people to pay their gold into the banks. To hoard gold, however, was not a crime but only a sin. In the same way the banks were not compelled to hand over the gold to the government. There can be no doubt, on balance, that taking gold and notes together and including both the gold and the notes held by all the banks—including the Bank of England—there was a continuous increase in the full legal tender money. After two years of war the increase had begun to attract general attention and at the present time the enormous amount of currency notes—always remember they are full legal tender—is at last causing general anxiety.

In any monetary system that is in a satisfactory state all the different forms of money are interchangeable at their nominal or par value. One of the worst signs of disturbance is when

some important form of money circulates only at a discount, or is the subject of specific depreciation. Let me give an example.

In former times, before the invention of paper money, the actual circulating silver coins, then the standard money, often became very much the worse of wear and tear—natural and otherwise. When the fact became recognized and it was found that coins of all degrees of depreciation were circulating side by side with better coins people began to refuse the worse coins except by weight. Of course the masses of the people had no means of estimating the metallic value of the coins and constant disputes arose especially in the payment of wages. The state of things that had come to pass in England before the great recoinage of silver in 1696 has been described in a graphic passage by Macaulay.[1]

"Nothing could be purchased without dispute. Over every counter there was wrangling from morn to night. The workman and his employer had a quarrel as regularly as the Saturday night came round. No merchant would contract to deliver goods without making some stipulation about the quality of the coin in which he was to be paid. . . . The simple and the careless were pillaged without mercy by extortioners whose demands grew even more rapidly than the money shrank . . . where artisans of more than usual

[1] Cf. *Money and Monetary Problems*, pp. 6, 7.

intelligence were collected in great numbers they were able to obtain some redress, but the ignorant and helpless peasant was cruelly ground between one class which would only give money by counting (tale) and another which would only take it by weight."

We have not within this country suffered from this particular evil of depreciation, but the standard measure has become uncertain in purchasing power and there is a possibility of a distinction being made between gold and paper prices as in the Napoleonic period.[1]

In this country during the war there has been no specific depreciation of any form of currency below its nominal value. It is true that early in the war, after the melting down of coin had been expressly forbidden by law, sovereigns were bought and sold above their nominal value in terms of notes. But in practice the sovereigns had already gone out of circulation and this premium caused no inconvenience.

All the other forms of currency, viz notes, silver, bronze, were interchangeable at their proper rates. In the same way the cheque system was kept in full working order. There was never the slightest suspicion attached to the banks—never any run on the deposits.

It has been long ago observed that when a

[1] Cf. The Bank Restriction of 1797 by R. G. Hawtrey, *Economic Journal*, March, 1918.

country such as this has a complicated and varied system of media of exchange, different kinds are found most convenient for different purposes. In fact it is this very convenience that is the chief cause of the different denominations and kinds of money. In the last resort, if all the media are on an equal footing, the proportion between the different kinds depends simply on the general convenience of people.

It follows then that if there is a general rise in prices and with it a general increase in the money (it does not matter for the present purpose whether the rise in prices is a cause or a consequence of the increase of the money)—it follows that if more money of all kinds is being used at a higher level of prices—while otherwise there is no particular change in the monetary habits of the people—much about the same [1] proportions will remain after as before the rise.

If then there is an abnormal increase in notes—and the notes are effectively circulated—we may be pretty sure that there will be a corresponding increase in the various forms of small change on the one side—in the silver and the bronze—and also a corresponding increase in the use of cheques for the larger payments.

This anticipation has been confirmed in this country in the present war. Corresponding to

[1] The proportions are not exactly the same. Cf. *War Finance*, p. 92, n.

the increase in the full legal tender notes there has been an increase in every form of token money. The increase in silver is specially interesting because there is a curious correlation between the rise in money wages and the increases in the issues of silver.[1]

There has also been a great increase in bank deposits and in the corresponding cheques.

Speaking broadly we may say that during the war up to the present time there has been a very great increase in the quantity of all kinds of money—that is to say of all the things that perform monetary functions—from the farthing up to the biggest kinds of cheques.

If then we mean by the term inflation an abnormal increase then it is unquestionable that there has been a great inflation of currency and of credit during the war.

In the paper to which I referred I compared the *rate of increase* over a series of years before the war of the different kinds of currency with the corresponding rates of increase during the war, and the rate of increase during the war proved to be abnormal.

Let us now pass from the facts of inflation (in the sense defined), from the abnormal increases in the forms of money to the causes and the consequences, or, if you prefer, to the correlations and the accompaniments.

[1] Cf. *War Finance*, p. 103.

We observe at once, taking a survey of the general financial situation, three outstanding features besides the abnormal increase in money. These other three outstanding facts are *first*, the abnormal increase of governmental borrowing; *secondly*, the abnormal rise in prices; and *thirdly*, the disturbance in the foreign exchanges. I will take them in the order named.

I

THE ABNORMAL INCREASE OF PUBLIC DEBT

Between the abnormal increase of governmental borrowing and inflation (i.e. the abnormal increase of money) there is a very close connection.

The policy of financing the war by means of voluntary loans was only possible after a certain point was reached by the abnormal increase of credit. If all this credit had been convertible into gold on demand—that is to say if the principle of the Bank Act of 1844 had been retained in the issues of the currency notes—very great restraints would have been imposed on governmental borrowing of the kind actually adopted.

In other words the government would have had to resort very much earlier and to a much greater extent to taxation. The resort to taxation would not only have lessened the borrowing directly but indirectly it would have imposed a severe check on extravagant expenditure. A

check would also have been imposed on the rise in the rate of interest on the public loans. Probably a forced loan at a very low rate would have seemed preferable to heavy progressive taxation to the people mulcted.

Taxation takes money from people and gives the command of the money to the State. A loan that is really taken from the savings or economies of the people has the same effect. Government borrowing is so far a substitute for all kinds of private loans.

But when the public loans are largely founded on credit (as came to be the case in this war as shown in the Currency Report) then inflation is inevitable.

When the State borrows in a great war it borrows by the hundred million and even by the thousand million in the course of a year.

But the millions borrowed are of no use unless they are broken up into the payments that are required to induce the different sets of producers and war workers to make their effort. The big loan is first of all broken into cheques. The contractors and sub-contractors and all the salaried classes may be paid by cheque. They in turn may make some of their expenditure by cheque. But in the end we are always brought back to the need for cash in the simplest sense. Cash is necessary for wages and for various retail payments.

In this country the principal form of cash in war time has come to be the currency note.

The currency note itself being limited to the pound and ten shillings has been supplemented by smaller coins. Naturally, as explained above, with the increase of currency notes we find an increase in silver and bronze.[1] In less favoured countries, where the war has brought misery and desolation as in parts of France and Belgium, the small change has had to be provided by small notes down to the value of one penny. Even in this country we were threatened with five shilling notes. And I may say in passing that if the mania for increases in money wages continues—if we elect to follow even at some distance the Russian example—we may still come down to notes of a shilling or even less.

The currency notes not only took the place of the sovereign and half sovereign in the hands of the people but they also took the place of gold in the whole internal credit system of the country.

What would have happened to the credit system and to the banks, if when the cheques were presented to obtain the cash for the payments of wages and the like the banks had to explain that gold for internal use was withdrawn from circulation and they had

[1] The figures are given in my *War Finance*, p. 488, 2nd edition.

no notes to take its place? The banks would have been bankrupt in the simplest possible meaning of the term. The primary duty of a bank is not to make good investments for long periods but always to meet immediate demands.

Some people are so bewildered by the masses of credit and the millions and millions of cheques that they forget that the banks must have a foundation in cash. No doubt for internal purposes notes may be used—and if the notes are legal tender and are universally accepted without demur the banks can meet all demands so long as they get the notes. If prices were to rise four-fold or ten-fold or any other fold, so long as the banks could get legal tender they could pulverize the war credits into wages and the like.

Were it not for the notes (supplemented by the token coins) the governmental loans would remain simply figures in bankers' books and the war bonuses and the other encouragements to patriotism would have died unborn.

During the first part of the war we were all astonished by the small increase in taxation. There was actually a general public demand for more taxation. Latterly this craving to be taxed has been more than satisfied in the classes whose incomes have remained the same, and who come within the effective range of the income tax.

Unfortunately, however, the delay in the use of taxation practically rendered exempt two very important classes. There was first the great class—great not so much in numbers as in wealth—which experienced a large increase of income through the war expenditure. The importance of this class is shown by the amount of the excess profits tax. In brief, a number of people have found at the end of the war that in spite of all taxation their net amount of monied wealth has been largely increased. When we speak of having paid so much of the war expenditure out of taxation we should remember that a great part of this revenue from taxation has its source in the debt already expended in enlarging incomes.

At the other end of the social scale a very large class has been practically exempted. If they have been taxed at all their money incomes have risen more than in proportion to the taxation. At first the rise in money wages was confined to the industries closely associated with the war. But gradually the rise spread to other classes. Every kind of industry or employment became infected with the idea that in spite of the war the pre-war standard of comfort ought to be maintained.

The maintenance of this pre-war standard was supposed to be secured by making money wages rise in proportion to the rise in the cost of living.

In many cases the war bonus more than compensated the rise in this cost.

Next the idea began to spread that not only ought the pre-war standard to be maintained but that it ought also to be raised. The large war profits were regarded as something of which labour had been defrauded in the first place. They could never have reached such a pitch if labour had received its fair reward.

This argument or complaint was then carried a stage further. It was first suspected, then asserted, then believed that before the war capital had been guilty of the same spoliation of labour.

And thus the final conclusion was reached not that the pre-war standard should be maintained but that it should be raised until the whole condition of the working classes was improved.

This means of course when interpreted in terms of taxation that the masses of the people instead of paying taxes ought to receive bonuses.

The bonuses like the excess war profits were really paid out of borrowed money. And in time the loans required could only be obtained by the aid of the inflation of credit and could only be pulverized into the cash required by excessive issues of paper money supplemented by token coins.

The inflation was in the first place a necessary consequence of the growth of the debt, but once

the inflation was well started, it increased the amount of the debt and accelerated its rate of increase.

How much thereby the real burden of the debt has been increased will be considered in the last chapter.

II

THE ABNORMAL RISE IN PRICES

I pass on now to the connection between the inflation and the rise of prices.

We have seen that in the course of the war the currency note has taken the place of gold for internal monetary use. Our internal monetary system before the war rested on the gold standard (as explained in the first chapter). During the war the gold, both for cash payments and for bank reserves, has been displaced by the currency note—that is to say for internal purposes. The case of external payments will be taken separately.

All the time, however, and even quite recently it has been maintained that the currency notes have had no effect on prices, but that, on the contrary, the prices rose first and then the notes were issued in response to the rise in the prices.

In the statistical paper already referred to, I showed that as a matter of fact, in the period covered by the inquiry, the rise in prices, as shown by the index numbers, showed a general confor-

mity with the issues of the notes with a three months' lag. That is to say, the rise in prices followed the increase of the notes by intervals of about three months.

Both in Canada and in the United States it was also found, by statistical investigation, that in these countries the rise in prices had followed, had not preceded, the issues of notes.

The alternative sequence is theoretically possible—that is to say under different conditions. As I observed in the introduction to my statistical paper, in the Napoleonic war period the great authority on the History of Prices, Thomas Tooke, showed that for a considerable period the increase in the note issues followed and did not precede the rise in prices.

It might have so happened in the first two years of this war—the notes might have lagged behind the prices. But in fact it did not so happen.

In the later stages of the war it is probable that the rise in prices in this country has been, to some extent, a reflex from the United States. The Americans told us we must pay more for our food and our prices rose. The bonuses rose, more notes were issued, and more bonuses followed. But our prices were not solely determined in sympathy with the American. And there were always other influences at work besides the currency at home and trusts abroad. In time there was the control of prices in this country—

though unfortunately the control was not begun until the prices had got well beyond the customary bounds.

There are two ways of showing that the inflation of credit and currency must have tended to raise prices, though the rise may have been partially modified and counteracted by other influences.

The first explanation is by reference to the Quantity theory of money. This theory, as I indicated in the first chapter, as applied to gold, is really a necessary part of the gold standard system. It is the connecting link between gold as the standard measure, and gold as the foundation of the medium of exchange.

Broadly, and in the rough, the theory is almost self-evident and can be confirmed by historical facts of the largest magnitude.

But, even in its simplest form the quantity theory, when we look into it, is not so very simple. It does not state that general prices respond simply to changes in the quantity of the money. There are always at least two other influences to be considered of primary importance. There is, first, the work to be done by the money. In the war, besides the necessary (and unnecessary) remains of pre-war work, there has been in addition all the war work (necessary and unnecessary). If the total work had doubled and so far the money had also doubled the level of prices

on this theory should have remained the same.

All sorts of variations may be played on this mode of relating the money and the work.

Then, again, there is also the use of the money to be considered in regard to what is called the rapidity, or velocity, or efficiency of the money. If money is used twice as much in doing a certain amount of work it is just the same as doubling the money. Now it is not easy, even roughly, to estimate the changes during the war in the work of the money of different kinds and the changes in the rapidity of the circulation.

To those trained in economics and familiar with the great historical examples of abnormal movements in general prices the picture of inflation in this war already indicated naturally suggests a great rise in prices.

But there are always practical men who mistrust the quantity theory and look on it as an economic will-o'-the-wisp, or a shibboleth, or something else academic and unpractical.

It seems then worth while, in explaining the connection between inflation and the rise in prices, to leave out the quantity theory and to approach the subject in what seems a more practical way.

Ask any practical man what prices depend on and he will answer: On demand and supply. This answer is also in complete harmony with economic teaching. (In fact the quantity theory

itself is an application of demand and supply to the case of money itself.)

But economic theory also teaches us that both demand and supply must be considered in every case, and in every case also, it is probable that both factors are complex and by no means simple. The practical man is apt to look either to supply only or to demand only, and in either case to concentrate on one aspect only.

In the course of our war when prices began to rise everybody began to speak of war scarcity. When imports were still rolling in owing to our command of the sea—when the land was full of things of all kinds (except chemicals) the war scarcity was made to do service. If actual scarcity was not visible still there was the scarcity to be expected—and accordingly there was speculation for the rise. When natural scarcity did not suffice to explain the facts there was substituted the artificial scarcity of monopoly. War is indeed very favourable to the emergence of artificial scarcity, and in general the rule is, that whenever monopoly emerges then also governmental control ought to emerge. The war scarcity of the things was also supplemented by the scarcity of tonnage and the means of transport generally.

The point is, that everybody who was anybody and not a cloud-capped economist, explained every rise in price by shortage of supply and

shortage of transport—either natural or actual, or expected, or artificial.

Every one of these elements, no doubt, contributed at different times in different proportions to the rise in the prices of all sorts of things and thereby to the rise in the general average.

But under no circumstances do prices depend simply on the conditions affecting the supply. The supply of a thing may gradually melt away, and in the process the prices may also melt away, so that in the limit the last specimen is given away for nothing. Why? Simply because in this as in all other cases we have to consider the demand. And demand does not mean simply desire to possess, but desire backed by means of purchase.

In the Far East famines are of frequent occurrence. And in the old days when the only money was silver, and not very much of that, scarcity even to the pitch of famine failed to raise prices very much. The desire was there in the greatest intensity, but the desire was not backed either by money or credit. In the present war, India has shown its progress in civilization by raising its prices, because a benevolent government has provided plenty of money.

It is the same in every country in the world, including our own. The demand for things has increased because the great mass of people have had put in their hands more purchasing power.

The fount and origin of this new purchasing power, the never failing stream, is the credit of the government.

The main stream has been diverted into innumerable channels throughout the length and breadth of the land.

As the scarcity became more real, owing to the unrestricted sinking by the submarines, prices rose in response to the scarcity. Wages had to rise in proportion. Such was the unlucky substitute for effective control and rationing. More and more money was poured into the channels of circulation and was spent in feverish haste.

And then people in general began to talk of the vicious circle. The whole country became covered by a veritable maze of vicious circles. And nobody of any importance who was likely to be listened to could suggest a way out.

III

THE DISTURBANCE IN THE FOREIGN EXCHANGES

I come now to the disturbance in the foreign exchanges.

The general rise of prices in this country, which is at any rate associated with the inflation of credit and currency, is the same thing as a

general depreciation of the pound sterling. If this general depreciation of our pound were part of a general depreciation of gold; or conversely if our rise in prices were part of a general world rise (caused for example by great gold discoveries), then the disturbance of the foreign exchanges would be only temporary, and would lie between the normal limits.

Under normal conditions of trade, the general levels of prices in the different countries, that are effectively on the gold standard, tend to conform to the general world level of prices. There are of course differences owing to cost of transport, tariffs and the like, but there is a general conformity.

If, in any one country prices were to rise in an exceptional degree, that would amount to a general depreciation of its currency compared with gold—the standard of the world prices. Imports into this high priced country would increase, exports would fall off, and there would emerge an adverse balance of trade. This adverse balance might be met for the time by the export of gold, or of securities, or by borrowing abroad, or by deferred payment, etc., but if the cause persisted—if the price level of the country in question remained relatively high, then its currency would fall below the par level with other currencies. That is to say, the *general* depreciation would be followed by or associated with a

specific depreciation. The specific depreciation is measured by the fall in the foreign exchanges.

During the first year of the war the level of prices in this country began to rise above the world level—in particular, our prices rose far more than the prices in the United States. Apart from this we were importing as much as we could from America of war supplies. Very soon an adverse balance of trade was established, and the American exchange fell in September, 1915, about 10 per cent. below the normal limit of a fall.

This fall was corrected by various devices, and the exchange was stabilized at about the normal rate; but the artificial character of the adjustment is shown by the fact that there was a continuous increase in the adverse balance of trade.

During the last year of the war the adverse balance was at the rate of sixty to seventy millions a month.

Since the war—quite recently—the artificial stabilization has been taken away, at any rate partially, and the exchange has fallen. Coincidentally the export of gold has been prohibited whilst the import is unrestricted.

The official embargo on the export of gold really gives official recognition to the specific depreciation of our currency in foreign exchanges. Probably the price of gold as a commodity in the

home markets will rise to a premium, and be also officially recognized.[1]

In the famous Report of the Bullion Committee the specific depreciation of the pound was measured by the fall in the exchange and by the rise in the price of gold bullion above the mint price, i.e. the premium on gold.

Attempts were made at the time to show that it was the gold that had appreciated and not our pound that had depreciated. Some of the practical men of that day argued that the pound sterling and the Bank of England notes could not depreciate.

The great majority of the House of Commons assented to this view. In time, however, facts were recognized and common sense prevailed.

To summarize:

Apparently we have now reached the stage of official recognition of the facts of specific depreciation.

It is doubtful if we have made the proper interpretation.

It is certain that we have not yet effectively applied the proper correction.

In dealing with this part of the problem we cannot take a surer guide than the late Lord

[1] The export recently of a certain amount of gold from the United States to this country in spite of the low exchange was accounted for by the *Times*, July 5, 1919, by the high price of gold given here for industrial uses.

Goschen's work on the Foreign Exchanges. Goschen, like Ricardo, was a combination of a firstrate economist with a firstrate man of business. In no later work have the great principles at the basis of the foreign exchanges been so clearly expressed and so closely connected with fundamental economic truths.

There are two chapters in Goschen that ought to be read specially at the present time. One is on the Interpretation, the other on the Correction of the Foreign Exchanges. It is vain to try to correct before you interpret. Diagnosis of the disease must precede the prescription of remedies. Otherwise the remedies may aggravate the disease.

Goschen himself gives one example of frequent occurrence: the case of over-importation associ ated with excessive issues of paper money and specific depreciation.[1]

As regards the causal connection he states: "Probably there are as many cases in which the depreciation of the currency is directly or indirectly the consequence of excessive importations as in which it is due solely to the errors and bankruptcy of governments. Often both influences are combined, taking alternately the position of cause and effect. Sometimes governments simply for their own purposes issue a quantity of paper money: the natural conse-

[1] Goschen's *Foreign Exchanges*, p. 73.

quence will be over-importation; prices will rise in consequence of the increase in the circulation and accordingly attract commodities from other markets, while the exports having risen also in price will be less easy of sale abroad. Or, over-importation takes place in the first instance, and governments in order to remedy artificially and apparently what can only be remedied by the cessation of the real primary cause commit the fatal error of increasing the circulation by an issue of paper money. They think thus to increase the means of paying the debts that are being incurred; but the only effect is still further to increase the evil; for importation instead of being checked is fostered by such a plan."

This passage exactly describes our present case. We are suffering in the first place from over-importation. In the war a great part of this over-importation was of the greatest national benefit. The imports from America were necessary for the conduct of the war. But an increasing part of the aggregate money value of these imports was due to the inflation of the currency and the associated rise in prices. This part was not a blessing—quite the contrary.

Consider the nature of the increasing adverse balance of trade during the war. More and more the increase is due not to increase in quantities but to increase in money values. No doubt the increase in values is partly due to prices made in

America. The rise in American food prices largely due to the work of great combinations imperfectly controlled, is one of the most disturbing features of the war. But the continued growth of paper money in this and other countries, and the continued expansion of money wages, fostered the money powers of the American monopolies. If our wages are to go on rising in proportion to the rise in the cost of living, we may be sure that the nominal or money cost of the living will go on rising.

We are brought back again to the fundamental economic truths which I emphasized in the last chapter. In the real economic relations between different classes in the same nation and also in the real economic relations between the different nations, we must recognize that money is only the measure and the medium. If you shorten any measure below the standard you do not lengthen the cloth or the drink or anything else that may be measured. All you do is to cheat the customer. But you cannot go on for ever cheating customers—the short measure will be allowed for.

The outside world will not continue to pour into this country masses of food and raw material—masses of necessaries and semi-necessaries and pure luxuries—unless it receives a corresponding mass of things in return. A mass of debts will be accepted for a time but only for a time. And

the mass of foreign debts imposes a peculiar burden on the borrowing country.

We are always brought back also to the same root causes of our financial difficulties, namely, the practical abandonment of the gold standard. The primary cause of the abandonment was no doubt the war. But the evil was exaggerated by the abandonment being made too suddenly and too completely. We delayed taxation and rushed into debt. The borrowing, dislocated from the gold standard, proved fatally easy. All the tempting devices to make the loans attractive —the little discounts and rights of conversion— now seem ridiculous. The easiness of the borrowing naturally encouraged extravagance. The extravagance was encouraged by the inflation and no real check was imposed on the monetary expansion. Our credit abroad was pledged to the utmost to pay for the imports. We may for a time longer go on deluding ourselves with the idea that we can improve the condition of the people in this country by advancing the minimum wages expressed in depreciated money—we may carry on for a time essential forms of production at a money loss and again make good the difference by borrowing in depreciated money, but we cannot go on deluding the outside world in the same simple fashion. In the end—and perhaps the end may not be so far off as it seems—the imports of real things must be paid for by the

exports of real things. And if exports are to be encouraged a stoppage must be made of the borrowing and of the inflation and of the artificial bolstering of prices.

ADDENDUM. (*September*, 1919.)

Since this chapter was written the Public Debt has increased by the excess of expenditure over revenue. The *Economist* index number has made a new record, being 295·6 for August, 1919, compared with 116·6 for July, 1914. The New York exchange has fallen below 4·15 as against 4·86 the old par. The adverse balance of trade is still growing.

CHAPTER III

THE BURDEN OF HIGH PRICES

Every one is familiar with the great rise in general prices during the war. Thanks to the labours of Thorold Rogers and others we have continuous records of prices for England over seven centuries. In that long period there have been notable movements in general prices but there has never been so great a *general* rise of prices compressed into so short a time.

During the war there have also been great changes in *particular* or *relative* prices caused by exceptional war demands and shortages. The extremity of the rise in these cases was checked by governmental control.

Consequent on the disturbances of relative prices there has been also a disturbance in the *familiar ratios* between important kinds of prices.[1] These familiar ratios are found in the whole range of prices—prices of labour, of consumable commodities, of transport, etc. As will be shown

[1] Cf. my *Principles of Political Economy*, Vol. III, Book IV, ch. 4, on Progress and Relative Prices.

later on, one of the most persistent causes of unrest during the war has been the disturbance of the familiar rates of pay for various kinds of work.[1]

The common idea that any movement in general prices is to be explained by a summation of the particular changes due to special changes in demand and supply is not in accord with theory or with economic history.[2]

General movements in prices are associated with changes in the quantity of money and the work to be done by the money. Changes in particular prices depend on changes in demand and supply affecting the particular things.

The difference may be made clear by an example. If the amount of money remains about the same and there is a great rise say in food prices due to scarcity, then there is so much less to be spent on these other things, and so far they fall in price.

At the beginning of the present war it was generally supposed that a number of luxuries would fall in price because necessaries would cost more and government would take by taxes money to spend on war materials. But it is doubtful if there is one single thing that has

[1] *Ibid.*, ch. 7, on Progress and Wages.

[2] The great exponent of the method of particular observation is Thomas Tooke in his *History of Prices*. See specially Vol. I., Introduction, p. 2 (1838 edition).

not risen in price. Probably most luxuries have risen at least two or three-fold.

Let me illustrate the difference between general and relative prices by one of the most striking cases in English economic history. About the middle of the sixteenth century there began a great upward movement in prices. It was caused, in the first place, by the depreciation of the currency by Henry VIII, and next by a great increase in the production of the precious metals, especially silver. Thorold Rogers found that every commodity went up in price except one, namely glass. In glass the improvements more than counteracted the general influences.

Perhaps you find these references to ancient history rather wearisome. Let me remind you that in the last dispatch of Sir Douglas Haig giving a general summary of the results of the war he said that, in spite of aeroplanes and high explosives, there had been no discovery of new military principles. The infantry was still the queen of battles. In the same way on the economic side the great economic principles have been abundantly confirmed. In particular we have once more been taught that a great increase of money raises general prices. In spite of cheques and gold-exchange standards, we are always brought down to the cash that pays the wages of millions of workers.

But the subject of this chapter is the burden of high prices, not the causes.

I shall begin with the simpler case, namely, the burdens of some of the special rises in prices of particular things.

Take first the rise in food prices. The war caused on the one side over-consumption (i.e. a greater demand) partly because the military used more and partly because they wasted more. The war also checked supplies especially latterly from overseas.

It is sometimes argued that a rise in prices under these conditions is a very good thing. So it is—for two reasons. It checks waste except of course by the military. It also stimulates production. In both respects so far a rise of price is good.

But *after a point*[1] the benefits are outweighed by the burdens. In the case of food the consumption cannot be reduced below a certain amount without intensifying the demand and raising the price out of all proportion to the scarcity. It was observed by Thomas Tooke, the great historian of prices of the Napoleonic war period, that a deficiency of wheat of one-

[1] The phrase "after a point" constantly recurs in economic reasoning. It calls attention to the great principle of continuity. In economics we pass by insensible gradations from one extreme to another—as for example, from prohibitive prices to satiety or even negative prices.

third, if not relieved by importation might raise prices tenfold. So great a rise in price would have had no beneficial effect whatever in restraining waste. In fact in the period of that great war the poor were forced to eat nettles and all sorts of things, and in practice, a large proportion of the people had to be provided with food by the State.

One of the best results of modern economic analysis has been to get rid of the idea that prices fixed by unfettered competition are *always* conducive to the general well-being: or to recall the old word that competition prices are "just" prices. On the contrary it may be said that, whenever there is a non-elastic demand, that is to say when upward movements in prices have little effect on the consumption, then some kind of control—*if* it can be carried out—is beneficial—and in the case of food supplies is absolutely necessary.

Consider now the effect of rising prices as a stimulus to *production*. Here again after a certain point, no increase in the prices can stimulate the efforts of the different sets of producers whether of capital or of labour. Not only so, but after a point in many cases, high prices—which of course are resolved into high profits and high wages—actually lessen efficiency.

The conditions favourable to a great rise in prices of particular things, such as natural scar-

city and exceptional demand, are also favourable to combinations of sellers, and an element of monopoly is added to the war scarcity and the war demand. A rise in prices due to monopoly is, in almost all cases, opposed to the public interests and ought to be controlled *if* possible.

Monopolies in war time generally impose exceptional burdens on consumers and instead of stimulating production they impose a check. The chief working rule of monopoly is to shorten supplies.

There is moreover an effect of these monopolies in war time that is far more prejudicial to the national interest than the *burden on consumers* and the *check to production.*

Such practical monopolies—and they arise not only in food and other ordinary necessaries but in all kinds of war necessaries—such practical monopolies give to particular producers or particular traders or manipulators or speculators very large unearned increments. The moral results of these undeserved gains is, in general, bad for the receivers themselves and it is worse to the nation at large. With regard to the winners of these large gains it checks parsimony in the good old sense and it stimulates extravagance in the bad old sense.

But the moral effect on the masses of the people in time of war is of far greater moment.

There is first of all, the constant clamour of

labour to share in these war gains. Everybody knows that one of the great causes of industrial unrest has been the enormous rise in profits.

But apart from the working classes, there has been a general feeling of indignation and disgust, that in a war for national existence large fortunes should have been made out of the national necessities. The feeling has been expressed by judges in the law courts as emphatically as by the man in the street.

By all means let exceptional efforts receive exceptional reward—let every encouragement be given to enterprise in war industries—but beware of encouraging the wrong people and the wrong kinds of efforts. And beware also of giving the largest rewards to those who on any fair analysis have done least for the conduct of the war.

The conqueror of Baghdad left a fortune of about one thousand pounds—any nameless man at the top of the tree in war contracts might make a thousand pounds a week or even a day all the year round.

These inequalities in distribution of reward to effort are not confined to the glaring contrasts I have just noticed. War produces all kinds of unearned increments and they crop up in all sorts of unexpected places.

So far as they are really unearned, that is to say due not to exceptional efforts or skill, but to exceptional luck or monopoly arising out of war

conditions, these unearned increments are morally bad.

From the moral point of view war requires of all of us sacrifice. The sacrifice is endured so that justice may be done. On the military side, the sacrifice of the nation has surpassed anything in our history. On the financial side in too many cases the idea of sacrifice has been overpowered by the idea of gain.

It is true that the excess profits tax has taken from 60 to 80 per cent. of the exceptional gains of capital. But it would have been infinitely better if the excess profits had never been made. Of course there are exceptions. I speak now of the general case.

Those who have gained the excess profits plume themselves on the fact that out of their abundance they have given so abundantly to the State in taxes.

Let us apply this idea of taxation in another way.

Suppose that at the beginning of the war the government had imposed taxes on all kinds of things—on necessaries for the people and on necessaries for the war. Suppose that all these taxed things had risen in price to the full extent of the taxes.

This I need not remind you is the normal case of taxes on commodities. After all the adjustments are made the taxes are supposed to fall

on the consumers; and the producers or the providers are supposed to get their ordinary reward. That is the theory—although in practice the transference of the taxes is not so easy and the producers are sometimes left with less than their usual gain.

Suppose, I say, that the government had imposed from the beginning of the war a mass of taxes of this kind and in such a scientific way that prices would have reached exactly the same heights as they have now reached with the things untaxed or very lightly taxed. Would not the popular outcry against such a hailstorm of taxation have been so great that the taxes could never have been carried out? How much greater would have been the outcry if these great war taxes had been farmed out to all sorts of interested people who were allowed to take 40 or 20 per cent. for their trouble?

No wonder that the excess profits taxes, or rather the conditions that render such taxes so fruitful, engender not only industrial unrest but moral unrest all over the land.

To prevent any misunderstanding the truth should be emphasized that excess profits arising out of inflation are on a totally different footing from normal profits under normal conditions. The adequate remuneration of capital is as necessary to economic well-being as is the adequate remuneration of labour. According to the old

analysis gross profits must provide (1) something in the way of interest. If you abolish interest you abolish one of the great incentives to the accumulation of capital. Even in the socialist state—if such were established as a going concern—some incentive must be given to induce the people to refrain from looking only to present needs. They must reserve some of their wealth for future production. They must create capital. They must be made to see that this capital—call it if you like social capital—will give a greater satisfaction in the future than if it is used up in the present. This difference in satisfaction or utility is the same thing as interest. In the socialist state you may say that the effort of making the capital is social and the reward is distributed socially. But the fact remains that to get capital you must offer interest.

How not to do it has been shown on a tragical scale by the Bolshevists. They have eaten up the capital of Russia. They have made no provision for the future. They are already feeling what it is to have no interest from capital.

In the same way provision must be made out of the gross profits (2) for all possible depreciations. If you do not set aside enough to replace all kinds of losses your capital wastes away. If you nationalize the railways and the railways are to be kept going you must provide out of the gross profits insurances for possible risks. If you pay

labour so much that nothing is left over for depreciation, either your railways will waste away or you must make good from other sources. But what other sources will be available when all the great industries are nationalized—with the idea of paying maximum wages to the operatives concerned?

It is the same with the remaining element in gross profits, namely (3) the earnings of management. The great source of earnings of management is the skill of the managers. Look at the reports of the manufactures in Russia under Bolshevist rule. They have eliminated the earnings of management and they have eliminated also the greater part of the production. Even in the socialist state in some form or other some inducement must be given to the best men to manage in the best way. Possibly they might be paid in honours—if the idea of equality admitted of any. Possibly public spirit might suffice. But how could the managers of great industrial concerns be chosen simply for their public spirit?

There are also other elements in gross profits that may be justified although they are exceptional. There is the reward for enterprise and the reward for exceptional ability. There is even the reward obtained by great combinations of capital (trusts) in so far as they save the wastes of competition.

In these days of insidious Bolshevism it is most necessary not to lose sight of fundamental principles by fixing the eyes on glaring exceptions. On a broad survey of the whole economic situation, most people would admit that so far as production is concerned bureaucracy is a poor substitute for private enterprise. And if all the bureaucrats were paid the same rates and the wages of management were just the same as the wages of type-writing, the bureaucratic management would be still less efficient.

At the same time it is admitted by all economists that even under normal conditions there are elements of profits that find no economic justification of the kind described.

There are always emerging occasions for monopoly and exploitation. Unlimited competition may often be an unlimited evil.[1]

In the course of the war these occasions for monopolies and exploitation have been multiplied and magnified. And over and above all the special influences that have promoted excess war profits in special cases, there have been the influences arising out of inflation which have brought about excess profits in industries which had no real bearing on the conduct of the war. There are thus two kinds of excess profits that arouse popular indignation. There are first the

[1] Cf. *The Report of the Committee on Trusts* (Cd. 9,236), p. 16.

excess profits made out of the necessities of the war, and there are secondly the excess profits made by all sorts of monopolies in trade out of the flood of new money poured out of the State loans.

After this long digression on the moralities of profit-making, I pass on now to the burdens imposed by a *general* rise in prices such as is due to monetary causes as distinguished from the special causes affecting the relative prices of particular things.

I have dwelt so long on the relative prices because there is a very close connection with general prices—namely, in this way. A general rise in prices aggravates the influence of the special causes. It aggravates the influence because the rise in general prices is never uniform, but takes place unevenly in different kinds of things and incomes. The general rise is felt first and most in the things that are already rising owing to the special causes.

In dealing with the burdens of general prices we must always remember that we are concerned with the transition from one level of prices to another. In itself it makes not the slightest difference whether general prices are high or low. The only difference—*if* once all the necessary readjustments have been made—is arithmetical. We use bigger figures than before.

But the difficulties in the readjustments are so great that in all the text-books it is laid down that the standard of value should have the greatest possible stability. Systems of money are bad in proportion as the money fails in this characteristic of stability of value.

Any gain due to a change in the standard of value—as for example to a general rise of prices such as we are now considering—means a corresponding loss to some other party. It is so far like gambling. In the exchanges of gambling the losses and the gains are exactly balanced in terms of money, whilst in terms of moral values as a rule both parties lose. Of course it might happen in special cases that the party who wins in a gamble will make better use of the money, but in general gambling involves to the nation a moral loss, and is held in check more or less by the laws of civilized states.

In the real exchanges of commerce and industry as a rule both parties gain. Both parties exchange the less useful to them for the more useful. There is a real gain in utility. This is the basis of all the exchanges of commodities and services by which civilized life is carried on.

If the money changes its value before the monetary contract is completed then one party enjoys a gain (and the other suffers a loss) beyond the original intent of the bargain.

As shown already, absolute stability of value

in the money measure is unattainable. But we ought as far as possible to avoid all causes of arbitrary change.

Amongst such causes of arbitrary change, the most important are those connected with a depreciation of the currency.

Before the invention of paper money governments resorted to the actual debasement or depreciation of the metallic money. They put more alloy in the coins or they reduced the weight.

The real effect of either malpractice was to increase the quantity of the money. That indeed was the object. The increase in the quantity raised prices.

In England there was only one short period when the metallic currency was intentionally reduced in value (under Henry VIII). As it happened this depreciation coincided with a great increase in the supplies of the precious metals from the mines. The consequence of the double event was that great rise in general prices which I mentioned as an example at the beginning of this chapter.

We may now look at some of the effects of this example which are of special interest to us by way of comparison with our own case. In the first place the unanimous opinion of contemporaries [1] was that the rise in prices of all the things

[1] Cf. Cunningham, *Growth of English Industry and Commerce*, Vol. I, p. 544 n.

concerned was due entirely to special causes affecting those things. Nobody thought of the money as the chief cause. Then as now—what the popular mind fixed on was "profiteering." That was the thing universally blamed though the word had not yet been invented.

There was this much truth in the popular view, namely, that—then as now—the conditions were favourable to combinations and monopolies and to what we call profiteering. At the time the old mediæval system was breaking up and all sorts of great economic changes were in progress. There was naturally a great disturbance of the familiar prices and the familiar ratios between the prices.

The new money aggravated these disturbances.

This general rise in prices (accompanied by a growth of monopolistic practices) caused a change in the real distribution of the national income. The trading and capitalist and employing classes gained at the expense of the working classes and of the middle classes not engaged in mercantile pursuits.

The consequence as with us was great social unrest. And as with us, statesmen were compelled to provide remedies.

The full effects of the rise in prices and of the social disturbances were felt in the reign of Elizabeth. Her great statesmen, first of all, had the courage and the wisdom to restore the currency to its proper standard.

But the rise in prices persisted, because it was partly due to natural causes, namely, increased supplies from the mines.

Two great attempts to remedy the consequent social evils were made by Elizabeth's advisers.

There was first the passing of the great code of labour, generally known by the misleading name of the Statute of Apprenticeship. There is nothing new under the sun. This measure practically provided for what we should now call a legal minimum of wages for all employments, for maximum hours of labour, and for compulsory arbitration. It provided also safeguards against unemployment.

The other great measure was the Poor Law which made relief compulsory where before it had been only voluntary.

Time will not permit of any examination of the effects of these measures of relief. The opinions of economic authorities differ according to the stress laid on different aspects of the legislation.

But two results are quite clear. The unrest was very real and very prolonged. And the remedies were only partially successful. The success varied with the effectiveness of the administration.

History is full of similar examples of social disturbances associated with debased or depreciated currency (and we may add with rising prices due to less blameful causes).

In the course of time one of the accepted rules of good government came to be that almost any measure was preferable to "tampering with the currency." "Tampering with the currency" became a recognized byword of bad government.

After the invention of paper money "tampering with the currency" became much more easy.

The chief abuse of tampering with paper money is making it non-convertible.

Many countries, probably all, have had experience of inconvertible notes. The degree of inconvertibility has varied, and in general, the evils have varied in proportion to the inconvertibility.

In theory it is allowed that inconvertible notes may fulfil some monetary functions quite well—or indeed most of them *within* any country—*if* only the issues are strictly limited. *If*—that is always the difficulty when everybody is finding excuses for breaking the limits.

In practice the evils of inconvertible notes have proved to be so great that they have been tabooed as much as tampering with the metallic currency. In fact to make notes inconvertible had come to be considered, before the war, as one of the worst forms of tampering with the currency.

As an example of the general economic opinion before this war, I may refer to the eminent Dutch statesman and economist Dr. Pierson. "In times of national trouble there is greater need than ever for guarding against a disordered cur-

rency. If the credit of the government be low, let it issue loans redeemable in a short time, and yielding a high rate of interest. If, after that method has been tried, capital still proves unresponsive, well then, let recourse be had to a forced loan.[1] But on no account let the currency be tampered with. The evils of war are sufficient by themselves without the additions which a disordered currency would entail."

The American economist, the late Professor Walker, devoted the second part of his standard work on Money to "Inconvertible Paper." He had the advantage of personal experience during the American Civil War, and gives an illuminating account of the principal cases of historical interest in other countries. His general conclusion is this: "The possibilities of evil which lie in the abuse of issuing such money are almost infinitely greater than those which inhere in a metallic circulation," (*Money*, p. 378).

Such is the teaching of history and of economic principles confirmed by history.

Let us now look at the social disturbances which may be associated with the general rise in prices in the present war in so far as the rise may be ascribed to the inflation, which, as already explained, has only been possible by the extensive use of *de facto* inconvertible paper.

[1] Holland has quite recently adopted the method of a forced loan.

The first great evil is that all sense of customary prices has disappeared. Prices of all kinds have got out of bounds. With the rise in prices, the first effect is a great rise in the profits of industry and commerce.[1]

The great yield of the excess profits tax shows clearly enough that there has been a very great rise in general profits.

Naturally enough when profits are rising, labour of all kinds clamours for its share, and in general the mere threat of a strike is sufficient to obtain the advance. In all the cases of governmental arbitration throughout the war, it is doubtful if there is one of any magnitude in which the award has not been given in favour of the workers. One chief reason apparently, is that the trades concerned were able to bear the rise.

In many cases in war contracts, the rise in wages simply meant a greater amount of profit, the contractor having a percentage on the cost. In other cases, a rise in wages was simply added

[1] A statement was published in the *Times* of April 25, 1919, of the profits obtained by wool spinners in Yorkshire, in connection with the provision of cloth for the Allied Armies. A case is quoted in which in the year before the war a firm made a profit of £1,621. During the war the profit has risen to £32,000 on the average for the four years of war after paying excess profits, super-tax, and income tax, and in spite of the higher cost of machinery and raw material.

like a tax to the cost, and transferred to the consumer.

There follows on the rise of wages in the favoured war industries a sympathetic rise in other industries. People are accustomed to a certain rough scale in the rates of pay—to certain ratios—for different kinds of labour. If some kinds get more money, then the other kinds think a corresponding rise is not only natural but equitable.

A notable example was furnished by the famous 12½ per cent. rise in wages of some of the munitioners through the easy benevolence of Mr. Churchill. The customary ratio was upset, and all the underdogs began to bark and bite.

Prices rose to meet the rising wages, and the general rise in prices was possible, because there was plenty of money. Different classes of labour pursued the rising wages, and as the old employments became depleted, those who were left asked for more and of course obtained more. There followed on the general rise of prices a general rise of wages. Then again, the new wages were put into the cost and prices rose again. The process has been described so often that at last people have begun to think that a general rise of this kind is inevitable in time of war.

But there is more to follow of the same familiar inevitable kind. The prices of all necessaries rose with the general rise. How then could the

workers live unless their wages were to rise? This led to the invention of the war bonus.

At the beginning the war bonus was supposed to be a temporary rise in wages to meet the cost of living. Month by month the bonuses have gone on increasing—even after the armistice. Side by side with the increases of the bonuses, attempts were made to control prices—but generally after prices had been more than doubled.

In spite of the rises of wages, and the bonuses and the governmental control of some prices, there has been a continued growth of industrial unrest. Labour generally is amazed and angry at the continued rise in profit, and at the rise of prices which render illusory the rise in money wages, except in the favoured cases where the money wages have risen more than in proportion.

Next observe that the rise in money wages engenders a spirit of extravagance.

In this connection we may recall the truth expressed in what used to be called Engel's law. Engel was a German, but he lived a long time before the German fall, and was probably not a greater sinner than the average European. At any rate his law sounds correct—if a little simple. It says that the prosperity of the working classes in general or in particular or in families, varies with the proportion spent on food and similar necessaries. That is to say, the less the

proportion so spent, the greater the prosperity. The greater prosperity is shown by the greater amount available for luxuries. There you have, in a quasi-scientific form, the explanation of a good deal of the war prosperity. When money wages have increased more in proportion than the necessaries, there is greater seeming prosperity.

Even in this case the prosperity is not very real. For all the favourite luxuries of the working classes (e.g. beer) have risen greatly and fallen off also in quality.

It is sometimes said that the general rise in prices has a stimulating effect on production.[1] And in a sense this is true. A revival of trade is generally associated with gently rising general prices and a depression with a fall. But when the rise in prices is due in the main to purely monetary causes, the first effect of the stimulant soon wears away. There is a tendency to slacken off and to call for a reduction in the hours of labour.

The cumulative effect of the processes I have just summarized, is seen in the general outcry for improvement in conditions. At the end of the most devastating war, the government is asked to spend immense sums for the benefit of the masses of the people. The war, it is supposed,

[1] This fallacy of inflation is very old. "It was set afloat by Hume in his *Essay on Money*." See Mill's *Political Economy*, Bk. III, ch. xiii., section 4.

showed the way to general prosperity by means of borrowing. The popular delusion is that now the war is over the borrowing can go on as before —but that the money borrowed can be spent in social reforms for ourselves instead of in the social destruction of our enemies.

On this occasion I will only observe that a popular delusion does not cease to have its effect as soon as its true character is exposed. Most reasonable people can now see with the eyes of the mind, that a rise in money wages and the fixation of high minimum wages in terms of money are feeble and belated remedies for a general rise of prices caused by inflation. If one of the root causes of the inflation is public borrowing then labour stands to lose by the increase of public debt, though in the first expenditure it may seem to benefit.

At this point I may also emphasize the most important practical deduction of this part of my argument. It is this. The working classes after the war will gain far more by a general fall in prices than by a continued rise in money wages. Their leaders seized the point even at the beginning of the war. They said to the government : Stop the rise in prices and we will stop the rise in wages. Unfortunately, whether by the force of circumstances or by the weakness of government, this counsel of perfection was not followed.

I shall return to this remedy for industrial unrest in the general survey in the final chapter.

The historical conclusion that a general rise in prices as a rule is adverse to labour and causes industrial unrest, is confirmed under present conditions by the comparative method.

All the world over we find that the great rise in prices is associated with great industrial unrest. I said before that in looking to the evils of a flood of paper money, we must never forget Russia. But in every country in Europe there are symptoms of the Russian discontent or disease, and with the actual oncoming of peace the danger will become more menacing. In this country we are apparently going to try to stay or prevent the malady by the methods of homœopathy. We are to borrow a few millions more to spend on the working classes by way of insurance against Bolshevism. The statesmen of this country and of Europe will have to resort to more drastic remedies. In some way or other a stop must be put to the rise of prices by inflation, and the process must be reversed.

It is not only in Europe that we find high prices and unrest. The same sequence is observed in India and in the Argentine, in Egypt and in Canada.

In different ways these cases are very illuminating. In India, besides other troubles, the rise in the price of silver has upset the gold-exchange

standard. The difficulty was met by the issue of small notes for one or two rupees. An enormous mass has been issued, and the metallic rupees have to a great extent been hoarded or made into ornaments. Politically this great issue of small notes, which from the nature of the case (i.e. the hoarding of silver) must become practically inconvertible, is dangerous.[1]

There is an excellent essay by Alexander E. Bunge, Director-General of Statistics in the Argentine, on the Purchasing Power of Money in the Argentine, 1910-18. He points out that three sets of prices have to be considered—the wholesale, the retail and the prices paid by the ordinary workman—the third being by far the greater and most subject to "profiteering."

A survey of the burdens of high prices would not be complete which did not include a reference to the middle classes, whose incomes are determined by salaries or by fees which have remained relatively unaffected. There is no need to cite examples—you are all familiar with cases of hardship.[2] But there is need to call attention to the economic principles involved.

It is the middle classes of this country who supply the greater part of the professions and the organization of the whole business of the country.

[1] Cf. *War Finance*, ch. iii. and prefatory note, p. 47

[2] The case of the London clergy is specially hard.

One of the best tests of national progress is the growth of the middle class as compared with the manual workers, on the one side, and the rich capitalists on the other.

The professional classes are also wage earners and are so treated by Adam Smith and all the great economists. Before the war the earners of the professional classes having regard to the cost and time of training and other natural causes of differences of wages, received on the average no more than an adequate remuneration for their services. In many cases they received less. The teaching profession as a whole was greatly underpaid as compared with other kinds of skilled labour. The same was probably true of the average of the medical profession, though in this case the possible prizes for exceptional skill and good fortune were greater.

I do not wish to lead you astray by emphasizing details. I ask you to look at the picture during the war, of the distribution of the burdens of the high prices on the great classes who make up the nations. Profits in general have risen, and in some cases very greatly, so that the rise has more than compensated the rise in the things on which the profits are spent. In many cases the makers of profits after all their taxes have increased their monied wealth. A large part of the working classes during the war also on balance improved

their economic position[1] especially if we take the family as the unit.

Relatively it is the middle classes who have felt most the burdens of the high prices. Relatively also, they have suffered most by taxation and they have contributed most to the war in the way of brains.

It is time to pass from the distribution of the burdens of the high prices to a consideration of the growth of the whole national burden.

With the general rise in prices, the government has had to pay more for everything consumed in the war. The general inflation has inflated also the debt. If we suppose that general prices have risen twofold we may say that so far the national debt has also risen twofold.

Given the general rise in prices, the increase in the capital value of the public debt was inevitable, but the same cannot be said of the increase in the rate of interest.

It might have been expected that with the enormous increase in the supplies of money of all kinds and with the restrictions on all forms of borrowing except for governmental purposes, the rate of interest would have remained low, that is to say, the rate at which the government could borrow. A great deal is said of the benefits of the method of continuous borrowing. The benefits of the method do not seem so great when we see adver-

[1] See *Labour Gazette* for May, 1919.

tised in every newspaper that the real yield to the war bonds counting the premium on redemption is £5 7*s.* 6*d.*

This great rise in the rate of interest on the internal debt and the corresponding increase in the burden, can only be explained by the failure to appreciate the true economic position.

For the growth of the external debt there is more excuse. If the United States chose to exact high rates, there was no alternative. We were obliged to borrow to pay for necessary imports.

But in the first years of the war the rise in prices was much more rapid in this country than in the United States. As a consequence, importation was unduly encouraged, and the adverse balance was so much greater than it need have been. In normal times over-importation would have been checked by the necessary export of gold and a consequent fall of prices, but owing to our inflation the fall never took place.

Accordingly we may say that the high prices in this country, largely due to inflation, increased the burden of our external debt.

In dealing with the burdens of the high prices, I feel that I have omitted many details of the first importance and difficulty, and yet I also feel that I have introduced so many topics that the general results may not be clear enough.

In conclusion, let me put the broadest results without qualification.

It is a commonplace of monetary theory and of monetary history that excessive issues of paper money amount to a system of indirect taxation. The Chancellor of the Exchequer stated the other day that 75 per cent. of the revenue was raised by direct taxation. He did not mention that the general depreciation of the currency amounts to a form of indirect taxation of all kinds of commodities—of which only a relatively small part comes into the treasury.

Not only do high prices due to inflation amount to a kind of universal indirect taxation, but they also involve in certain cases the grant of exceptional bounties on production.

The general result is that as compared with the pre-war scheme of national distribution of income the distribution has been much more inequitable. Some classes have suffered exceptional reductions, other classes have gained unearned increments. The inequities of the new distribution are the principal cause of the prevailing unrest.

The worst of it is that these evil effects do not cease with the war. We are left with a dead weight of public debt, internal and external. Even with the first year of peace, the estimates allow for a further increase of debt.

CHAPTER IV

THE BURDEN OF PUBLIC DEBT AND TAXATION, AND THE NEED FOR THE RETURN TO THE GOLD STANDARD

Public Debt and Taxation are large subjects with a large literature. The Return to the Gold Standard is the most difficult financial problem of the present day.

The main object of the present chapter is not to survey so wide a field but to get rid of some misunderstandings and fallacies which prevent in my judgment any fair view being taken.

One of the greatest of these fallacies is that an *internal* public debt, with the corresponding taxation for interest, imposes no real burden on the nation at large. On this view all that is involved is a transfer of resources from one set of people to another set with no real diminution of the aggregate national wealth.

The case of an external debt is supposed to be quite different. The distinction was forcibly put by Mr. Bonar Law in a speech in the House of Commons (April 2, 1919) in the debate on the

payment of indemnities by Germany. "Probably," he said, "the external debt of one thousand millions would prove a greater handicap to our trade and a greater obstacle to the recovery of our prosperity than the whole of our debt incurred at home."

Every one can realize on simple inspection the main burden of an external debt of one thousand millions.

It we reckon interest at only 5 per cent. it means that we must send out yearly, without any return, fifty millions worth of exports. But the real interest is more because we have to provide for the extinction of the principal, and we have to make our payments in dollars which cost so much more with every fall in our currency. These evils would be there even if the external debt were funded for a long period. But when the debt is for short periods and has to be renewed, the debtor country is put in a kind of economic subjection to the creditor country. In spite of all the good feelings aroused by union in the great war it is not good for this country to be so largely indebted to the United States. Our first effort should be to get rid of this debt, and our share of the German indemnity, if it materializes, could be put to no better purpose.

There can be no doubt that a heavy external debt imposes some peculiar burdens, but the suggestion that a large internal debt is relatively

negligible, is michievous. The practical force of the underlying fallacy has been shown by the careless expenditure of borrowed money during the war. By the process of borrowing (say) a thousand millions, it was supposed that the money was taken from one set of pockets and put into another set with no real difference to the nation at large. And if it really made no difference why should we take thought for the morrow ?

The same root fallacy we must suppose was the chief cause of the continued rise in the rate of interest on the debt until it settled down at over 5 per cent. with a variety of curious bonuses. What did it really matter to the nation at large if the rate of interest was 3 per cent. or 6 per cent. ? The same sleight of hand of the tax collector would transfer six pounds and its multiples from one set of pockets to another set just as easily as three pounds and its multiples. The national wealth would remain unimpaired and the discomfort of the taxpayers would be balanced by the equal comforts of the receivers of interest. And in the meantime all sorts of public benefits could be conferred on the labouring voters by the simple process of paying with promises to pay.

The war came like a thief in the night—the comparison is just in more ways than one—and no doubt the master of the house could not be very particular about the choice of means of

defence. But to continue emergency measures during years of war shows that in the popular belief the policy was sound in itself.

It is beyond the scope of my argument to consider the political expediency or necessity of the growth of public debt, but it is a principal part of the argument to show the reality and the nature of the economic burden.

The chief practical conclusion of the Report of the Currency Committee was that governmental borrowing must cease at the earliest possible moment.[1] By way of illustration reference was made to large schemes for housing. The Committee must have been aware of the very strong opinion in favour of this particular scheme, and I presume they chose the example for that very reason. Even in this case—that was the implication—even in this matter of housing, in spite of its urgency—the government ought to advance warily and not to be led away into great additions to public indebtedness.

As yet at any rate this final and fundamental recommendation of the Report has been apparently disregarded. And the real reason is that the masses of the people and the representatives who record the voices of the people are under the

[1] The Victory Loan (July, 1919) is issued ostensibly for funding the floating and short-term debt—a most desirable object. Two hundred and fifty millions *only* is for new debt!

impression that borrowed money is a kind of treasure trove.

The real burden of an internal debt is twofold. *First* there is the burden imposed when the debt is incurred—the indirect effects of which may last a long time. And *secondly* there is the burden involved in the continued payment of the rate of interest. It is the first of these burdens that the Committee on Currency had most in view. They were more alarmed apparently at the effects of the expenditure of the borrowed money, than at the rise in the aggregate burden of the interest.

The root cause of their alarm was the belief that a continuance of public borrowing meant a continuance of inflation and all the evils attendant on rising prices, and disordered foreign exchanges. These evils cannot be annulled at once. It is easy enough to upset the apple cart, but not so easy to gather up the apples. Sixty millions for donations seems a small sum, but it is big enough to serve for an illustration. If the sixty millions is borrowed it means that so much purchasing power is added to the existing mass—and the expenditure so far raises prices or prevents the fall. I cannot forbear pointing out in passing that this example of the donations recalls the experience of the bad old Poor Law at the beginning of the nineteenth century—which threatened the whole country with ruin. After

the reform of 1834 this example was always quoted as a thing to be avoided. The aim of this bad old Poor Law was, no doubt, most laudable, namely, to guarantee to every one a minimum standard wage. If the employers did not give enough then allowances were to be given in aid of wages. Employment was to be offered to the unemployed near their homes, and with other advantages. As a consequence, the general condition of the unemployed became preferable to that of those employed in the old way, especially in agriculture. I do not say the present case is on all fours with this old bad example, but the principle is the same. In many cases the people concerned find it more to their advantage to be unemployed with donations than to be employed without.

To be paid for doing nothing is one of the worst forms of unproductive expenditure. And this leads to another forgotten principle of economics which the older economists made abundantly clear, namely, the distinction between borrowing for productive and for unproductive expenditure.

The simple practical rule for productive expenditure is, that after a term of years the undertaking should repay the original expenditure. Even in that case the State should not lightly undertake vast industrial enterprises. If the effort of voluntary associations would suffice, then in general, it is preferable. The reason is that the

State is already overburdened with work of a public character.

Productive expenditure on the part of the State, if properly laid down, will in time pay its own expenses and increase the flow of the great national dividend. It will augment both capital and industry. Unproductive expenditure, on the other hand, tends to leave nothing behind but debt and unemployment.

It may happen as in the case of a war for national existence that very large unproductive expenditure must be undertaken. But apart from indemnities and material conquests of value, the expenditure on war leaves a dead weight debt instead of various forms of productive capital.

Besides war, as Adam Smith himself allowed, there are other forms of unproductive expenditure which on moral grounds ought to be incurred. But even in the most urgent cases, regard ought to be paid to the means of payment. If we were to pull down all our universities and build greater, so that we could give a university education and maintenance to all the young people in the country, they might conceivably be better men and women from the human point of view—but how would the loaves and fishes and the other material necessaries of the country be provided for?

And in particular how should we provide the exports to pay for the imports of food and raw materials?

Look again at Mr. Bonar Law's distinction between the internal and the external debt. Why is the external debt considered so troublesome? Because the interest, and eventually the capital, must be paid for by exports of corresponding monetary value. But these exports can only obtain the corresponding money value by being sold in foreign countries. And how can they be sold if by the piling up of *unproductive debt* in the home country the cost of production is raised? Month after month since the armistice new bonuses have been given to labour. The railways are to be run at a loss, and the coal is to be produced at a loss. You cannot get continual and general rises in wages, and keep down the cost of production.

It is precisely the same with profits and the various elements of which gross profits are composed.[1]

Take interest. If government laps up all the circulating capital and pays a high rate, how can

[1] The point was most effectively put by Adam Smith in explaining the injury to British trade caused by the high rate of profit consequent on the monopoly of the colonial trade. "Our merchants frequently complain of the high wages of British labour as the cause of their manufactures being undersold in foreign markets; but they are silent about the high profits of stock. The high profits of British stock, however, may contribute towards raising the price of British manufactures in many cases as much and in some perhaps more than the high wages of British labour." *Wealth of Nations*, Book IV. ch. vii., p. 247. (Nicholson's edition.)

the rate of interest on new industrial ventures be kept down? Look at the prospectuses of the new companies and the rates of interest offered and expected.

Again, consider the element of risk in gross profits. Insurance against the risk of losing the capital is part of gross profits. With the uncertainty as regards the course of prices and of taxation every venture has to put or does put a higher value on the risk.

The remaining element in gross profits is the so-called wages of management. Economic analysis shows that fundamentally the wages of management are subject to the same kind of causes of variation as other forms of skilled labour. The popular idea that profits even under normal conditions always consist, for the most part, of very large unearned increments is not true. In the late war there was, no doubt, far too much of this element. But with the necessary falling off in war contracts, and with the necessary fall in some important prices, these exceptional profits ought to fall or to cease. The conditions which led to the excess profits tax must in time disappear. But the wages of management after the war must remain relatively high if industry is to be carried on in the best way. After the war the call on management will be far more severe, and unless the payment is proportionate the ability will seek its reward in other countries.

The general result is that, altogether *apart from the burden of the interest* the piling of a great public debt for unproductive expenditure imposes a burden on all the industries of the country. *There is a general rise in the money cost of production, and indirectly our foreign trade, and with it our home trade, is put into those very difficulties which we fear so much from our external debt.*

(2) But there is this other burden to consider, namely, the burden of the interest and of the sinking fund—if we ever get to a real sinking fund. A sinking fund made out of more debt is only a delusion.

The first burden that I described is usually overlooked altogether, I mean the rise in the cost of things in general. When we come to the interest, the rise in cost is actually converted by some enthusiasts into a blessing in disguise.

When the plain man in a momentary revival of plain common sense says that the interest of some four hundred millions for public debt is twice as great as the whole of our public expenditure before the war, he is reprimanded. He is told that he has forgotten the rise in prices. If prices have risen twofold (and that is the least computation) then so far the national income has risen twofold.

This blowing up of the national income is supposed to make the burden of the interest on

the national debt quite negligible. What is £400 millions of interest? A beggarly ninth of the new national income properly inflated. Very little more than a tithe—a sort of ecclesiastical tribute for the benefit of the poor.

Just as the burden of the debt is made proportionately less by estimating the national income in depreciated currency, so also it is argued by some people that the burden might be made still less by still greater depreciation.

It was observed by Adam Smith, that when once national debts have accumulated to a certain degree there is a scarce single instance of their having been fairly and completely paid. If the public revenue, he said, had ever been liberated from this dead weight charge, it had been through the bankruptcy of the State; sometimes by an avowed bankruptcy, and frequently by a pretended payment.

The pretended payment is by the depreciation of the currency. And Adam Smith states emphatically that, if necessary, open bankruptcy is far preferable.[1]

The depreciation of the currency, whether specific or general, amounts practically, as already

[1] Since Adam Smith wrote, all nations have recognized the dangerous policy of bankruptcy or repudiation. They have still to learn that an avowed bankruptcy is preferable to a pretended payment by depreciation of the currency.

shown, to one of the worst forms of taxation. It is also a species of repudiation, and so far injurious both to public and to the private credit of the nation.

If we suppose that, in the course of time, prices will gradually fall to the pre-war level and that the stability of the foreign exchanges will be restored, in a word, if the gold standard is effectively restored, we must face the real burden of the interest—that is to say, if it is a burden.

Let us consider now the pleasing fiction that the payment of interest is simply a transfer by the tax-gatherer from one set of pockets to another set.

We may begin by comparing the payment of interest on the national debt to the payment of the interest of the debentures of a great company. The company has issued the debentures to get new capital, and if the venture is sound, the company earns, not only the interest on the debentures, but something over which goes to swell the ordinary dividends.

But if the company can no longer earn the debenture interest, the only alternative is to go into liquidation and pay back the borrowed capital.

The interest for the national debt must also be earned—earned from year to year. In the last resort, if the State takes a larger share from the great national dividend, so much less must be left

for distribution between the other claimants: namely, the three great factors of production—land, labour and capital.

Consider first the case of land.

Taxation of (1) *land values* used to be a popular cry, though the bloom has been rubbed off by the expense and trouble of the valuation.

If exceptional taxation of land values is not to injure the productive power of the State, great care will have to be taken. Take agricultural land. If special taxation prevents the keeping up of the capital already sunk in the land, and prevents the fixation of new capital in the land, the gain of taxation is altogether outweighed by the loss in productive power. A fundamental rule of taxation is as far as possible to leave the sources unimpaired.

Even the taxation of building land is not so easy as it seems. The shortage of houses is partly to be ascribed to the over-strained haste to catch the unearned increments of the builders and ground landlords.

Taxation that falls (2) on the *income from capital* tends to check both the accumulation and the employment of capital. Of course under certain conditions (such as prevailed in some, and perhaps in most, industries in the present war) there may be large elements due to partial monopoly or exceptional demand. There may be what economists call quasi-rents. And as Adam

Smith observed, the gains of monopolists whenever they can be come at are, of all subjects, the most proper for taxation.

But if the special taxation strikes at the fair reward of enterprise and management, then both the amount and the productiveness of the national capital are injured.

A similar argument applies to (3) *labour*, but as the tendency is to make labour tax free, or at any rate not subject to exceptional taxation, this case may be put aside.

It only remains to notice that the taxation on capital will indirectly affect the wages of labour, and so far tend to lessen the productive power.

At this point comes in the pocket to pocket argument. It is said that the fundholders who get the proceeds of the taxes will themselves pay them out in the purchase of things, and so far employ labour. What really happens is that the fundholders will consume their allotted share of the annual national income, and it is improbable that any considerable part of this consuming power will be diverted so as to add to the capital of the country. The fundholders so far have their income secured. It is the makers of terminable incomes, the managers of capital, the professional classes and the like, who, out of their savings, try to make provision for the future.

The difference in taxation of what we call earned and unearned income is justified solely by this idea of the permanence of the source in one case, and the necessity of providing a capital source in the other.

If, then, the general effect of the taxation for the debt is to take from the possible savers and give to the probable spenders of the national wealth, that wealth will not grow in the same way.

Turn again for a moment to the debentures and the like in industrial companies. Here the payments are taken from going concerns which, in most cases, are making a surplus profit. But the point is that the debenture interest must itself be earned by the various companies. To do do this the capital in its various forms must be kept up, and depreciation guarded against.

But the national debt (i.e. the war debt) of itself earns nothing. The capital it is supposed to represent has already been, for the most part, destroyed in war. It is certainly not renewed. In a word the national debt when incurred for unproductive purposes, such as war, is a dead weight, and the interest is a dead weight, first charge on the real earnings of the country.

The pocket to pocket argument has been pushed to an extreme by Professor Pigou.[1] "To sim-

[1] Compare the article by Professor Pigou in the *Quarterly Journal of Economics*, February, 1919, p. 252.

plify the discussion," he says, "I shall begin by studying a representative man so situated that what he pays in taxes to finance the debt, exactly corresponds to what he receives in interest, and in repayment of the principal of his war loan holdings. In these circumstances it is obvious that the interest money merely comes out of one pocket and goes into another, and that a subjective burden is excluded as completely as an objective one." Where, he asks, is the burden? The economic position of the man remains just the same. He has paid away, say, one hundred pounds and he has got back one hundred pounds.

It is overlooked that, if as fast as the interest accrues it is taken away in taxation, the man has so far no income at all. He cannot pay it away in taxes and also in bills for house books. The operation described as so simple is in fact repudiation: simple robbery. The government really ceases to pay interest at all.

A general repudiation would leave the actual material capital for the time being unaffected, but before this war the one great lesson every country had learned was that repudiation did not pay.

It is characteristic of economic fallacies that they are generally founded on some perversion or misunderstanding of a truth. The underlying truth here is that the mere change in ownership does not alter the physical amount of the material

national wealth. If all the things in a country are continuously bought and sold, the aggregate value may be supposed to remain the same. But in general it would not. The mere transfer from place to place, or from person to person, or from time to time, may add to the values of the things. The Census of Production showed that the getting the things from the factories to the consumers might involve a 50 per cent. rise in price.

A better example of the truth aimed at in the proposition that the aggregate value is unaffected by transfer is the bank money of a system of banks closely connected. The total fund of deposits may be supposed to remain the same whatever the transfers in the different accounts. We read, for example, that the payment of the dividends on the national debt and the like really only involves a transfer from the government account to the accounts of various bankers, and the balance remains, after a short interval, undisturbed.

But the real burdens of public debt and taxation are not to be got rid of by a change in book entries.

Instead of saying that an internal debt involves no burden, it is much nearer the truth to say that it involves just the same burden as an external debt.

Let me also take a simple case. Suppose a profiteer—of the kind displayed in *Punch*—suppose such an one after the war retired with,

let us say, twenty million pounds. And suppose that being a fervid patriot all these millions are in war bonds paying 5 per cent. With this million a year by way of interest, he can make a real retirement and lay out a garden of delights with a mansion in middle and, in the words of the old song, servants in uniform handing the drink and all the rest of it.

What really happens is that year in, year out, the labour and capital of the country has to provide the stream of comforts and discomforts that flow into the stomachs of this profiteer and his retainers. There are no returns in the way of exports from the garden of delights, and we may suppose that everything is consumed on the premises. The government sends the interest in large cheques and the profiteer pays the bills in smaller cheques.

What difference would it make if the profiteer retired to America or any other place? No real difference. If he becomes an absentee the things are sent out to him directly or indirectly —real exports must be sent out; and if he remains in the country the things are sent shorter distances.

This idea that an internal debt involves no real burden overlooks the great foundational truths regarding the production and the distribution of the national wealth.

The broadest of them all is that unless you secure to people the fruits of their economic

efforts, these efforts will not be forthcoming, or not to the same extent, or not to the extent required for national welfare. Labour sees this well enough as regards labour. Capital sees it well enough as regards capital. The cold-blooded economist sees it well enough as regards both.

That is the truth in the abstract. And in the concrete the best illustration repeated many times in history is that taxes that take away the fruits of labour and taxes that take away the fruits of capital, unless restrained within moderate limits, in the course of time destroy their source.

This old truth is more quickly realized under modern conditions with the immense improvements in the means of transfer, both of labour and of capital, from one country to another—from the country where taxation is heavy to the country where it is less heavy.

Even supposing that all the taxes are made to fall, in the first place, on capital, and it is only the capital that flees away or ceases to be renewed, labour without capital loses the power of production.

The question now arises: If the burden of the debt is real—if the burden left by the war is a real burden—what is to be done with it?

I pass over the simple suggestion that the burden should be cast off by open repudiation.

Repudiation in whole or in part means national bankruptcy. And we may be quite sure that national bankruptcy cannot take place without a multitude of individual bankruptcies. Open repudiation would only be possible with open revolution—a revolution that would mean not a change of government but a change in the whole economic system.

Fortunately in this country this is an alternative that for the present (June, 1919) may be put aside.

Next there is the method of disguised or indirect repudiation. This method assumes many forms. The two that have found most favour in these days are, first the levy on capital and next, the continuance and increase of inflation.

The levy on capital has been argued out of the field and the conclusion of the discussion has been summarized in the Budget speech of the Chancellor of the Exchequer.

But here as always in economic problems we are confronted with the principle of continuity. It is hard to distinguish between a levy on capital and death duties that may reach 40 per cent. of capital value.

If the death duties are to be used as part of the ordinary revenue of the State and expended in bonuses to labour or unproductive social reforms, then it may be argued that even a levy on capital, if the proceeds were used to extinguish part of

the public debt, would be preferable to death duties.

The continuance of inflation and of the methods of inflation is a more popular remedy. Although condemned in principle it survives in practice. Deflation is too troublesome for practical politics.

The government is practically helpless so long as the popular clamour insists on more social reforms on borrowed money.

Altogether apart from borrowing for social improvements there is, amongst the industrial and commercial classes, a strong current of opinion in favour of more inflation. If the word is avoided the thing is certainly fostered. All sorts of facilities are to be created for the expansion of credit and with credit of currency.

At this stage of my general argument I need only say that, if inflation is to continue and increase, then the evils of inflation will also continue and increase. As before there will be first the rise in profits, next the rise in wages, and lastly the rise in salaries. In the end there will be an abundance of money and a relative scarcity of everything else. The false prosperity will continue so long as there are any real savings to consume and so long as we can keep off the rocks of foreign trade.

The outlook is not cheering even if we take a parochial view. It is still less cheering if we take an empire view or a world view. World

inflation means world unrest. World unrest means a serious danger of social revolution.

If then these dangers are to be avoided, what are to be the remedies?

Just now what we want to get hold of is not so much special measures, as great lines of economic policy which will be followed by the stable elements of society.

We must realize that the wastes of war can only be made good by hard work and not by soft money.

With the abandonment of soft money the soft ways of making money must also be abandoned.

During the war there has been a general shortage of production except for war requirements. Large profits have been earned by high prices. This is not a matter of conjecture. Values have risen more than in proportion to the diminution of quantities and more than in proportion to the costs of labour. We must try to get back to the pre-war methods of larger production with narrower margins for profit. It is hopeless to tell labour to work more and produce more if there is to be artificial scarcity to secure higher prices. Everybody has heard of the great glut of fish in the ports, but no one has heard of the great fall of prices in the shops.

The method of reduced output (or reduced sales) has been also followed by labour. The universal cry is for more money, for less hours. The latest

suggestion by Mr. Smillie is that four hours a day is quite enough.

When the war was threatening us with absolute irretrievable ruin in case of failure—when we read of the devastations of other countries, we were willing to consent to any kinds of measures that kept the country going as a fighting machine.

But now that the victory has been won the same economic evils will not be submitted to without reason given.

If capital still tries to continue the methods of scarcity and monopoly and high prices—I do not say all capital but enough to be noticeable—there is a real danger of social insecurity. The insecurity may fall short of revolution—the Bolshevist example has been a warning—but our whole economic system rests on security, and insecurity far short of Bolshevism may destroy industrial enterprise.

Capital is asking in some quarters for governmental insurance against falling prices. I venture to say that falling prices are a necessary insurance for the security of capital in general.

A continuance of the rise in prices is not only dangerous to capital because it may bring social revolution into the range of practical politics, but it is dangerous also in a more particular way—the way namely of *foreign* trade.

To this country foreign trade in absolutely necessary. In the end we must pay for the

greater part of our food and of our raw materials of manufacture by our exports. How can we restore our export trade if we are always raising our prices? And simple restoration is not enough. Our export trade must be *augmented*. We have to pay interest abroad instead of receiving interest from abroad. No one supposes now that the interest received from our loans to our allies will meet the loss of pre-war interest from foreign countries at any rate in any reasonable time.

Before the war our large excess of imports was accounted for only partly by the interest received from abroad. There was also the payment for our freights. We were the world's greatest carriers. After the war we shall have to face the competition of the United States and possibly of other countries.

Another element of the invisible exports by which our apparent adverse balance was met was the commission due to us as the great financial agents of the world. Here again with the practical abandonment of the gold standard and the growth of American foreign trade,[1] our financial commercial supremacy is threatened.

Even yet the list of dangers to capital of the high prices is not completed. Before we can

[1] The United States has now an excess of exports over imports of over £700 millions a year, about equal to our *adverse* balance. Coincidentally there has been a great expansion of American credit in foreign countries.

restore and augment our export trade we must make efficient our pre-war capital means of production. The actual material depreciation of the war must be made good. How can it be made good if the money cost is to be still rising? And how can the cost of the restoration of productive works fail to rise—not only by the general rise in prices—but by the diversion of productive labour and material to unproductive social reforms?

If these social reforms that involve a large expenditure are to be carried on over a term of years, the range of prices must be brought down, and common prudence suggests that the works should not be arranged for except on a scaleof falling prices.

To saddle the country with a great increase of local debt is still more to restrict the productive power of capital.

Speaking broadly, if capital does not aim at suicide, capital must consent to a stoppage, and even to a reverse, in the rise of prices.

The case from the point of view of labour is still more clear. As already explained, one of the greatest truths of economic history is that labour as a rule benefits by falling prices and loses by rising prices.

For some years before the war, mainly as the result of monetary causes, e.g. the increase in gold supplies and greater economies in the use of of gold, general prices were rising all the world

over. And all the world over, although money wages were also rising, they were not rising in proportion to the rise in prices of the things of most importance to labour. In the *Times* of 1912 appeared a series of articles on Labour Unrest in which the principal part was assigned to the rise in prices.

It is only by the prevention of any further rise in prices that any real meaning can be given to the proposal for universal minimum rates of wages. What is the use of fixing minimum rates of money wages if the money is to have less and less purchasing power?

Practically every scale of minimum wage will be out of date before it is published.

There is the less need to press this point as from the beginning of the war the best leaders of labour admitted that falling prices were to be preferred to rising money wages.

There is always the question of possible unemployment. This is the scarecrow that is set up to frighten labour from the fields of abundance. Labour is told that capital cannot carry on if prices fall. Capital, it is true, cannot carry on with the methods of restricted output; but how can restricted output be a cure for unemployment?

What we have to get back to is large scale production with lower ranges of prices and narrower margins of profit.

We are now brought face to face with the great practical difficulty:—How is the rise in prices to be stopped? How can we get back to the level of pre-war times?

If the argument elaborated in these lectures is correct, and it is simply a restatement with modern instances of well-tried economic principles, the answer is simple enough so far as the general lines of economic policy are concerned.

The prices can be reduced (or stayed) either by a limitation of the money, or by an increase of the things, or by a mixture of both processes.

The increase in the things may seem the more simple process. But it is not so. When once a nation or the world has got used to unlimited issues of paper the production of the things will never overtake the issues of the new money—unless that new money is limited. And with rising prices, it seems to be to the interest of producers to check supplies and get monopoly prices. The method of abundance is not given a fair chance. There is still less chance for this method if the country is taught to believe that foreign competition must be restricted so that high prices may be obtained in the home markets.

It seems, then, that if the rise of prices is to be checked, a stop must be put to the abnormal increase—that is to say the inflation—of money of all kinds, and if prices are to be brought down,

the quantities of the kinds of money must be contracted.

As already shown, all the forms of money are interconnected. They rise and fall together. Any general contraction must be applied to the root causes of increase. In practice the root cause is govermental expenditure of borrowed money. Unless the money borrowed is effectively taken from the pockets of the people—unless it means really a transfer of expenditure from the individual to the State—unless, in short, the State borrows old money, it must make new money.

The first condition then of a check to the rise in prices is the restoration of the balance of revenue and expenditure. If new expenses are to be incurred somebody must have the courage to reduce old expenses. If we are to spend more on houses then let us spend so much less on the armies of bureaucracy. Let every social reformer, especially if he is a minister in charge of a spending department, indicate what kind of old expenditure he proposes to raid in order to start his new scheme. Let the system of rationing be put in force in the expenditure of the public money. We ought not to borrow more and we do not want to tax more. The only alternative is to change the nature of the expenditure.[1]

[1] Another example of the great principle of substitution to which modern economists, e.g. Marshall, assign so much importance.

It is only by the recognition of the need for a real check on the growth of public expenditure, that the abnormal increase of money, which is the main cause of the rise in prices, can be stopped.

When the need is seen, the process of deflation can be begun with some hope of its continuance.

We cannot at once get back to the effectiveness of the pre-war gold standard. We cannot at once restore absolute convertibility into gold of our inflated paper money.

But we can prepare the way. In the first place a rigid limitation ought to be put at once on the increase of the currency notes, the chief form of our legal tender.

Secondly, when a stoppage has been put to the increase, the maximum of issues ought to be still further reduced by successive stages, until the notes bear a reasonable proportion to the gold held as cover.

In these two steps we prepare to apply the great principle by which our pre-war system of note issues was regulated, namely, the principle of convertibility. The method of maximum issues is only one of the supports of the principle of convertibility. There will be no effective limitation until convertibility is secured.

These conclusions are in harmony with those of the Report of the Currency Committee, except that in the Report less stress is laid on the prin-

ciple of convertibility and more on the special method of direct limitation.

It is impossible on this occasion to discuss the best practical measures to adopt in the period of transition.

With regard to provision for emergency currency in case of need, the real difficulty is to define with proper limitations the cases of need. During the war all the trouble has come from the fatal facility of providing for the issues of emergency currency, and from the failure to provide for reduction when the emergency has passed.

It must never be forgotten that in a real crisis of the first magnitude, no legal rules could prevent the issue of some kind of emergency currency. The rules would be broken. The aim ought to be to prevent the emergency or the crisis rather than to provide remedies after it has occurred. If it is known that the remedy is always ready the prevention becomes too lax.

Under present conditions, the most important task is to provide for the reduction of the volume of money, and the great requisite for the task is moral courage. In banking very often the test of moral courage is a rise in the rate of interest. No method of deflation can be effective which does not make some people—and indeed a good many people—uncomfortable. The donations for doing nothing and the jobs invented for doing worse than nothing must be shut down.

Probably one or two millions of people will be made to feel very uncomfortable. But the real working classes ought not to feel discomfort from the change. On the contrary, as I have already tried to show, they stand to benefit by falling prices more than by rising money wages.

Until we are prepared to face trouble and difficulty in retracing our steps we shall go on wandering so much farther from the right way.

But we cannot reach the Delectable Mountains unless we first get back to the right way.

The conclusion of the whole matter may be put in the words of the greatest master of pointed moralities—John Bunyan.

At one stage of their journey the pilgrims found the right way very rough. They were tempted to go over a stile into By-path meadow. "When they were gone over, and were got into the path, they found it very easy for their feet; and withal, they, looking before them, espied a man walking as they did (and his name was Vain-Confidence). . . . But behold the night came on and it grew very dark . . . and Vain-confidence fell into a pit. . . . So they called to know the matter, but there was none to answer. . . . And now it began to rain and thunder and lighten in a very dreadful manner, and the waters rose amain. . . . But we must not stand thus, let's try to get back again [said Christian to Hopeful]. . . . by this time the waters were greatly risen, by reason

of which the way of going back was very dangerous (then I thought that it is easier going out of the way when we are in, than going in when we are out) . . . They are in danger of drowning as they go back. . . . They sleep in the grounds of Giant Despair. . . . He finds them in his grounds and carries them to Doubting Castle."

But at last they got back to the King's highway and went on till they came to the Delectable Mountains.

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